FEDERAL FINANCE

A STUDY OF THE PROBLEMS OF PUBLIC FINANCE ARISING IN FEDERAL CONSTITUTIONS

By

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WITH A FOREWORD

BY

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Finance Member of the Government of India, 1928–34

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FOREWORD

By Sir GEORGE SCHUSTER,
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I AM very glad to write a few words in commendation of this clearly written book. It appears at a very opportune moment. There is no subject in the constitutional field which is of greater interest to-day than "Federal Finance," not merely in India, but in many countries of the world. The establishment of satisfactory relations between a Federal Government and its constituent states is a problem which, during the past century and particularly during recent years, has exercised the minds of the framers of constitutions, of the statesmen who have to work under them, and of the law courts which have to interpret the statutes in which they are embodied. These problems as affecting the development of economic and financial policies have, as is well known, been very prominent recently in the United States of America, Canada and Australia. It may be permitted to one who has a great admiration for the ability of Indians

and also for the standards of public administration which have become traditional in India to express a confident hope that India will have much to teach the world in the successful solution of these problems. To all who must perforce be interested in them Mr. M. Mir Khan's book will be an extremely valuable guide, and it is a pleasure to recognise that a young Indian, taking advantage of the close ties which exist between his country and ours, has produced so admirable a work.

GEORGE SCHUSTER.

PREFACE

THE object of this book is to analyse the problems of Public Finance which are peculiar to federal constitutions. From a study of the financial systems of the various federal governments, I have attempted to draw out and analyse the problems arising out of their constitutional nature. Different countries have tackled these problems in different ways. I have made a comparison of these methods in order to study their relative merits. The central theme of federalism is the division of powers between the federal and the state governments. In this study of the financial aspect of federalism, therefore, the main issues relate to the distribution of financial authority between the governments of the states and the federation.

I made my first acquaintance with problems of financial decentralisation while working in the Finance Department of the Government of India, at Calcutta and Nagpur and in the Currency Department at Madras and Bombay. As an officer of the Civil Service in Hyderabad, I had the opportunity to assist in the art of financial administration and to compile the Financial Code of the

State. Here I acquired a knowledge of the problems facing the states and provinces of India under a scheme of federal organisation.

During my research at the London School of Economics, I have received valuable advice and guidance from Dr. F. C. Benham, for which I record my debt of gratitude. I wish to thank Professor P. B. Potter, of the Institut des Hautes Etudes Internationales of the University of Geneva, for useful suggestions. The sources from which I have drawn are indicated in the bibliography. Appendix II is the result of a study made with Mr. S. K. Shastri, to whom I am extremely thankful for his generous assistance.

M. MIR KHAN.

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July 15, 1936.

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PART I
Federation and Finance

CHAPTER I

THE SPHERE OF PUBLIC FINANCE

PUBLIC FINANCE relates to the revenue and expenditure of the state and its subsidiary organisations. Its study comprises questions of the division of the burden of the state among the individuals and the incidence and effects of the various modes of taxation. It examines the effects of the financial activity of the state on general economic conditions and discusses the social benefit accruing from it.

The subject may be divided into two parts : the science of pure finance and the discussion of financial principles. The first category would include, for example, the incidence and repurcussions of taxes and the determination of the economic effects of a particular system of taxation, as the effects of a progressive or proportional tax on private incomes or the result of a customs duty on national production. The second part would deal with problems like the desirability of a certain tax to perform a certain social function or the graduation of a tax to charge one class of persons more than another.

Some authors confine the subject to problems of

the first sort, and exclude the others as belonging to the domain of politics, constitutional law, or morality. The prejudices of interested politicians who pose as financiers may, perhaps, create distrust and repugnance in the mind of some thinkers who prefer to limit the field of public finance. But this point of view disregards the fact that financial phenomena are inextricably connected with political, social and moral factors. The majority of great political or social reforms have had financial causes, while most important financial problems have been decided under the influence of political and social causes. As Jéze says, "even if governments do not by their financial institutions pursue social ends—which is hardly true anywhere—it cannot be denied that the financial system by affecting the fortunes of individuals has *social* consequences as well as economic and financial."[1]

On the other hand it is erroneous to suppose that the sole aim of the financial activity of the state is to create a complete equality of incomes among its members. According to this thesis, as originally exposed by Guicciardini, "there can be no true justice or real equality, unless the taxes bring all of us down to the same economic level."[2] Closely

[1] "Les Sciences des Finances."

[2] "La decima scalata in Firenze." Quoted by Professor Seligman.

allied to this is the view of Professor Wagner who ascribes to public finance a "socio-political" mission. The state, according to him, should no longer be satisfied with raising an adequate revenue, but should consider it a duty to interfere with the rights of private property in order to bring about a more equitable distribution of wealth.[1]

It is certainly necessary that the great inequality of fortunes and incomes of individuals and families existing in modern communities should be reduced in order to bring about greater harmony in their economic life. The conditions affecting the distribution of wealth have, therefore, to be altered. In this matter the state may be expected to keep in view an equality of treatment. It should hold the balance equal and afford equal rights and opportunities to all individuals. This principle of legal justice, which should be the basis of state activities, will produce equality of opportunity, equality of treatment. This is what is meant by legal equality. But any other sense of legal equality, as Professor Seligman says, "which would force an equality of fortune in the face of natural inequalities of ability, would be a travesty of justice."[2]

The trend of the argument for complete equality would run as follows. According to the law of

[1] Finanzwissenschaft, Chap. II, Sec. 159.

[2] "Progressive Taxation."

diminishing marginal utility, the more of a thing a man has the less does he value each successive unit of it. Therefore the marginal utility of money to a man would be less if he had more of it than it would be if he had less. The sum total of utilities would consequently be maximised if transfers were made from the rich man to the poor man, and this should be the end of the financial activity of the state.

The argument is based on truth, but it has its limitations. As Professor Robbins says, it " begs the great metaphysical question of the scientific comparability of different individual experiences."[1] If one person has two different ways of using a unit of income, it would be possible to compare his behaviour by exposing him to the two stimuli in question. It is, however, not possible to say whether a given increase in a person's income results in a proportionate increase in his satisfaction from his income. If his income is doubled, his satisfaction may be more or less than double.

When it is a question of two different persons, it is not possible to measure whether one person derived greater marginal satisfaction from an income of £1,000, or another person from one of £2,000. The assumption, therefore, of the equality of human behaviour, though not false, " can never

[1] " Nature and Significance of Economic Science."

be verified by observation or introspection," and cannot be taken to be scientifically exact.

There is no doubt that measures designed to reduce inequality are beneficial in so far as they improve the education, health, strength and the efficiency of the present and future citizen workers. They reduce wastage of possible talent resulting from want of equality of opportunity. They tend to increase the national income by promoting industrial harmony. Equality in opportunity or in the provision of the necessities and amenities of life is thus beneficial and just. But men are not made equal in their ability to contribute to national production, nor are they made equal in their ability to enjoy and to make the best use of it. A measured equality in their shares would, therefore, neither be just nor bring about the greatest measure of benefit. As Dr. Benham says, " there is great danger that ill-considered measures of this kind may diminish incentives to work and to discover and apply better methods of production, and may lead to the curtailment of the volume of saving, most of which comes from the larger incomes. Hence there are definite limitations to the power of a state to promote prosperity by changing the distribution of its national income."[1]

The communist ideal cannot, therefore, be taken as the basis of public finance. The state, like any

[1] " The prosperity of Australia."

other human organisation, requires the means necessary for the performance of its functions. A social club needs sufficient resources to maintain the services and facilities for which it has been formed. A labour union must have funds to promote its interests, and a scientific society needs an adequate provision for its expenses to fulfil its mission. It follows that public finance is the nurture by which the body politic is maintained. It would not dictate, therefore, the governing principles of the state, but would, while thus working the machine, promote the attainment of the ideals of the community. It should be considered neither to be the means of "taxation for revenue only," nor as the engine charged with the sole purpose of rolling down incomes to uniformity. In the words of Professor Seligman, "the direction of its activity depends on the general attitude of the legislator towards social and industrial matters."[1]

The sense of what constitutes happiness is

[1] "Progressive Taxation." The following passage is also noteworthy: "From the principle that the state may modify its strict fiscal policy by considerations of general social utility to the principle that it is the duty of the state to redress inequalities by taxation is a long and dangerous step. If this were one of the acknowledged functions of government, it would be useless to construct any science of finance. There would be one single principle: confiscate the property of the rich and give it to the poor."

individual and personal. This is axiomatic not only of individual, but also of group psychology. The nature of the social order desired for the country may vary among different communities and from time to time. While at one time the community preserved the *laisser aller* state of the society as the ideal for the attainment of the "good life," it may in another period consider it more desirable to curtail the principle of individualism and bring into closer communal control the various aspects of the life of the individual. Again, while one community may desire the continuance of private enterprise in its economic life, the other may subject it to corporate control to form an "Ethical State," and yet another may seek to eradicate it under a complete communal co-ordination of the work of the individuals.

A community, therefore, directs its financial activity towards the fulfilment of its communal ends, the achievement of the aim for which it exists, the common good. The keynote of public finance has accordingly been described to be the Principle of Maximum Social Advantage. Though the practical application of this principle may often be difficult,[1] a sound system of public finance will

[1] "The aims of the state are vague and indefinite as contrasted with the profit-making aims of private enterprises. Legislatures and executive officers perform functions which do not always benefit anyone directly or even confer benefits

strive to secure the maximum social advantage from the operations it conducts.

As Dr. Dalton says, the first test of social advantage " which suggests itself is the need to preserve the community, assuming it to be worth preserving in its existing form against internal disorders and external attacks."[1] From a more strictly economic point of view the conditions governing the welfare of a community, are the improvements in its productive power and the improvements in the distribution of what is produced.

The improvements in the productive power of the community secure a larger output per head of economic wealth with a smaller effort. This increases social advantage and facilitates increased saving. By improvement in distribution is meant the reduction of the inequality of incomes of individuals and families and also of their variability in point of time, especially among the poorer sections of the community. A reduction in inequality will distribute the national income " more in accordance with the individual and family needs

that are easy to locate. Further the character and extent of state services must necessarily be a matter of compromise with always a minority dissatisfied as witness the local disputes as to the need of educational facilities or the national conflict as to the desirable extent of military preparedness." Jensen : " Problems of Public Finance."

[1] " Public Finance."

and with capacity to make good use of income." [1] A reduction in the variability of income from time to time will bring to the individual more assurance of his welfare and will make the economic life of the community more stable.

In connection with the principle of Maximum Social Advantage, it is, however, necessary to remember that it is impossible to lay down definitely for all times, what signifies social advantage and what constitutes its maximum. Human institutions are continually under a process of evolution, and the state as it is understood to-day is not an "absolute category." Its ideals, its functions, its very nature has been changing through ages and will continue to change. Hence any generalisation about what its ideals should be and how they are most advantageously attained should be relative from the point of view of time and the period of the evolution of the human mind.

It is possible, moreover, that a given system of public finance reduces inequality of fortunes, but does not contribute as much towards increase in the economic production in a community, as an alternative system would which, however, could not sufficiently reduce inequality. If it is a question of choice between—for example—increase in production and reduction in inequality, a decision cannot easily be taken as to which of the

[1] Dr. Dalton: "Public Finance."

two or what state of balance between the two, will bring about the maximum of social advantage.

The business of finance, therefore, through its operations of collecting an income and spending it, is to serve the community in maintaining itself and improving its welfare. The purpose for which the community exists and strives are the guiding principles of its governmental activity and public finance functions as the life-blood of this activity.

CHAPTER II

PUBLIC FINANCE IN A FEDERAL STATE

§ 1. *Nature of a Federal State*

In an organisation constituted not by individual persons but by several states, the sphere of public finance is analogous to its domain in a unitary state. It is useful to examine the nature of a federal state, for that will determine the function of public finance in the federal field.

The idea of federalism, though of modern development, is of ancient origin. It has been traced in the age of the city states of Greece when the Achæan League was formed.[1] The Swiss and the German confederations illustrate its existence in the Middle Ages, leading later to the formation of the federations in Central and South America.

These political organisations differed in the degree of cohesion among their members. The loose type of organisation, or the confederation, stands at one extreme, while a unitary state with a large measure of decentralisation stands on the

[1] See Freeman: "Federal Government in Greece and Italy."

other. Between the two types may be located the federal state which thus differs from the two extremes in the measure of cohesion among its component parts.

The federal idea is not in conflict with any type of government. The constitution of Imperial Germany and that of Switzerland illustrate that it is adaptable to monarchial as well as democratic governments. The constitution of the United States and that of the British Dominions prove again that the idea is suitable no less to parliamentary than to presidential democracies. And the federal constitution of India achieves cohesion among the provinces, hitherto parts of a unitary state, and the autonomous states ruled under the monarchical principle.

As Bryce says, " the true value of a political contrivance lies not in its ingenuity, but in its adaptation to the temper and circumstances of the people for whom it is designed."[1] The federal form is highly adaptable to the peculiarities of each case, and this fact constitutes its great worth and strength as a political system. If, therefore, an attempt is made to define an orthodox federal policy, from which the less " regular " forms may be considered as deviations, it would be an imperceptible appreciation of one of the federations as compared with the others.

[1] American Commonwealth I (357).

What distinguishes a federation (Bundesstaat) from a confederation (Staatenbund) is the greater part played by the common organisation for the common good.[1] The German Bund of 1815, with not even sufficient contribution of army contingents from the states for common defence, cannot be called a federation as it neither possessed the machinery nor the authority to deal with many matters of common welfare. The central authority in a federation must therefore have, by common consent and obedience of the member states, the legal power over matters governing *national* welfare and must also have, through an effective legislature, executive and judiciary, the administrative machinery to deal with those matters.

A federation is thus distinguishable from a confederation by having an effective control over national welfare. But, on the other hand, it is different from a unitary state in as much as its member states, as contrasted with the provinces of the unitary state, possess constitutional powers over matters which are their own concern. The common consent and obedience of the member states not only mark out the sphere of the federal

[1] "The federal state differs from the confederation—whose main purpose is defence—by the much larger amount of the competence of the central system." Kelsen. For an exposition of his "legal federalism" see Sobei Mogi: "The problem of federalism."

authority, but also constitutionally preserve the sphere of their own activity. This constitutional autonomy is altogether different from the authority delegated to the provinces of a unitary state as a measure of decentralisation.[1]

§ 2. *Division of Powers* [2]

The division of powers between the federal government and the member states is, therefore, the basic characteristics of the federal state.[3]

[1] " Enfin, il serait tout à fait erroné de croire qu'une certaine division des pouvoirs corresponde mieux à la nature de l'Etat fédéral ; en effet l'on a vu que deux traits essentiels caracterisaient la décentralisation fédéral : l'autonomie constitutionelle et la participation des Etats-membres à la formation de la volonté federale. C'est la seule chose importante, en ce sens que si minime que soit la compétence des Etats-membres, ce sera un Etat fédéral s'ils possedent l'autonomie constitutionelle et s'ils participent en leur qualité de membre à la formation de la volonté de l'Etat, et au contraire, la compétence de la collectivité-membre peut-être très large, s'etendre sur des matieres très importantes, il n'y aura pas d'Etat fédéral si elle ne possède pas ces deux caractères." Mouskheli : " Théorie juridique de l'Etat Fédéral."

[2] An interesting example of the division of subjects is afforded by the constitution of the newest federation, India. Appendix I.

[3] " The distribution of powers is an essential feature of federalism. The object for which a federal state is formed involves a division of authority between the national government and the separate states. The powers given to the nation form, in effect, so many limitations upon the authority of the separate states, and as it is not intended that the

The bond of union is indissoluble, but within their respective spheres the federal and the state governments are supreme. In a unitary state, on the other hand, the authority enjoyed by the provinces is delegated by the central authority and is revocable. The distribution of powers in the different federal constitutions is effected generally by the method of "enumeration and residuum." The powers of the federal government are enumerated and the residuum is vested in the states or *vice versa*. In the United States and Switzerland the federal government is given only those powers which are enumerated in the constitution or are implied therein. All other powers, except those expressly forbidden by the constitution, are reserved to the states. The constitutions of Australia, Mexico and Brazil follow the same rule.

It is, however, impossible to make such a division exclusive and everlasting. Political experience has shown that, in spite of a judicious demarcation of the spheres of the federal and state governments, certain subjects remain of common interest to both. The life of a community or a union of communities is organic in the sense that it cannot be completely

central government should have the opportunity of encroaching upon the rights retained by the states, its sphere of action naturally becomes the object of rigorous definition." Dicey: "Law of the Constitution."

divided up into parts to be dealt with by the government of the union or the unit exclusively.

To provide for this a certain sphere, common to both governments, is recognised in most constitutions. On the assumption that in case of conflict between the federal government and the government of a state, the viewpoint of the federal government will be more conducive to the welfare of the union as a whole, the constitutions recognise the principle of federal supremacy. The German constitution very explicitly lays down that "federal law over-rides state law."[1] But this supremacy operates in the field which is not exclusively marked out for either of the two governmental authorities.

A study of the division of powers in the American constitution would show that five classes of governmental powers may be distinguished: powers reserved to the federal government, powers reserved to the state governments, powers forbidden to the state governments, powers forbidden to the federal government, and powers exercisable by both the federal and the state governments.[2] The powers in the last category relate to the sphere common to both authorities. A

[1] Article 13. cf. also Constitution of W.S.A. (United States), Art. VI; Venezula, Art. 7; Argentina, Art. 31; Brazil, Art. 63; Switzerland, Art. 113.

[2] Bryce: "American Commonwealth," I. The powers forbidden to both the authorities relate to the grant of titles, appropriation of property or indemnifying legislation.

definite provision for concurrent jurisdiction is a marked feature of the scheme of the division of powers adopted in the more recent federations.

The German constitution distinguishes three classes of subjects in this common sphere: concurrent, conditional, and normative. According to Article 7, the States may legislate on a group of subjects on which the Federal government can also legislate. Article 9 lays down that for the purpose of "uniform regulation," the Federal government may pass laws affecting "all matters concerning public welfare and the maintenance of public order and security." This would give the Federal government power to legislate under certain conditions, in the domain reserved to the States. Articles 10 and 11 lay down that as regards a group of subjects, the legislation of the Federal government will prescribe certain forms and that of the States will regulate its own affairs according to those standards.[1]

The constitution of the Dominion of Canada separately enumerates the powers assigned to the Federal as well as to the Provincial governments.

[1] "The Constitution of the German Empire," Oppenheimer. "General guiding clauses, main lines, the detailed application of which, their elaboration in special points, can be capably and desirably undertaken by the individual states, especially from the standpoint of their adaptation to the special conditions of the various states." Auschütz quoted by Dr. Finer.

It then lays down two residues, one for the Federal government and the other for the Provinces. To the Federal government it reserves "such subjects as are expressly excepted" from being assigned exclusively to the Provinces. To the Provinces it reserves "all matters of a merely local or private character." The two residues are thus undefined and in certain cases concurrent.[1] The Federal legislation in this field will, in the interest of Canada as a whole, over-ride the legislation of a Province.

The federal constitution for India as laid down by the Government of India Act of 1935, enumerates the subjects reserved exclusively for the Federation, and those reserved exclusively for the Provinces. As regards legislation in a common field, it lays down that:

(*a*) In case of a "Proclamation of Emergency" by the Governor-General "that a grave emergency exists whereby the security of India is threatened" the Federal legislature can pass a law affecting any of the subjects in the "Provincial Legislative List."[2]

(*b*) In the subjects enumerated in the "Concurrent Legislative List"[3] the Federal legis-

[1] Kennedy: "The Constitution of Canada"; "Constitutional Documents of Canada" (MacDonald's speech). Clement: "The Law of the Canadian Constitution." Keith. Responsible Government, I.

[2] Section 102 Govt. of India Act, 1935.

[3] Schedule 7 to the Act.

lature may also pass laws and that in case of conflict in the concurrent field the Federal law shall prevail,[1] and that

(*c*) in the matter of cases relating to subjects not included in the Federal, Provincial or Concurrent Lists a decision should be taken by the Governor-General in each case as it arises.[2]

The scheme of the division of powers in India thus includes what in the German constitution are "conditional" powers of the federal government. But it does not lay down the residuum of powers either to the Federal or the Provincial governments. It adopts the unique method of *ad hoc* decision in each case by the Governor-General personally, who is expected to seek assistance in the matter from the Federal judiciary.[3]

[1] Section 107 of the Act. "The subjects themselves are essentially provincial in character and will be administered by the provinces and mainly according to provincial policy." Section 233: Report of the Joint Committee on Indian Reforms.

[2] Section 104 of the Act.

[3] "We have already expressed our approval of the device adopted in the White Paper for the purpose of meeting this difficulty, under which the Governor-General, acting in his discretion is made the arbiter between conflicting claims of centre and provinces. This in effect preserves, in the limited sphere of the concurrent field, the existing relations between the centre and the provinces which excited the admiration of the Statutory Commission." Report of the Joint Committee.

The scheme adopted in India is peculiar again in as much as the Provinces and the States forming the Federation will have differences in status. The Federal government will have powers in a State with regard to those subjects in the "Federal Legislative List" only, which are accepted by the State concerned in its "Instrument of Accession" to the Federation. There is no concurrent list of subjects in which the Federal government may also legislate, as in the case of the Provinces. The residuum of powers rests with the States.

The division of powers thus being the main problem in the structure of a federal state, it follows that the member states and the government of the union should attach great importance to the constitution which lays down the spheres of their autonomous activities. "A federal state derives its very existence from the constitution." [1] Except in the German and the Swiss constitutions, where no distinction is made between constitutional and ordinary legislation, the supremacy of the constitution is affirmed in all federations. It is the instrument to which reference is made in all cases of conflict, and which through the doctrine of *ultra vires* keeps the various authorities within their bounds. The ultimate power resides in the sovereign people who framed it and the method adopted for alterations in the constitution may

[1] Dicey: "Law of the Constitution."

render this exercise of ultimate power by the people either exceptional, as in the United States with the prescribed majority for a proposal and its ratification, or more frequent, as in Switzerland through the referendum and the initiative.

Owing to the great importance of the constitutional document the judiciary is entrusted with the task of interpreting the constitution when necessary.

A departure may be noted from this rule in the German constitution, where the judiciary is not expressly vested with this power, though attempts have been made by the courts to assume it.[1] The Swiss courts review the acts of the Cantons, but have no power to question an act of the Federal legislature as being unconstitutional. Any tendency, however, of the Federal legislature in Switzerland to disregard the constitution is checked by the people themselves by the exercise of their ultimate authority.

The federal government as the guardian of the interests of the community as a whole is given the right of predominance in the field of concurrent legislation. It is presumed that in this sphere which is not exclusively federal, any action of the federal government will be based on considerations

[1] The Supreme Financial Court assumed the power of interpreting the Constitution in 1925 in the matter of the Devaluation Bill.

of common good. It will assume the responsibility of overriding the law of a state in the concurrent field in cases when the interests of the union as a whole require it. This predominance of the federal government is also due to the fact that it is generally given the power of intervention between two states in conflict. It is only natural that being the third party it is presumed to be impartial and is entrusted with this power *vis-à-vis* the states.

The supremacy of the federal government is, however, scrupulously defined and limited by the constitution. In the spheres reserved to the states the independence of their authority is guaranteed. Any act which encroaches upon their autonomy is *ultra vires* and void. It may be remarked that the federal government may, nevertheless, employ the agency of the state governments in its exclusive field, and that a state government may utilise the federal agencies to administer subjects exclusively its own. The independence guaranteed by the constitution to a governmental authority in its sphere does not preclude it from employing the agency of the other for its own purposes. This method is employed for motives of economy, convenience and efficiency. The administrative machinery is, therefore, not completely separated in spite of the autonomy in the exercise of their powers by the various authorities.

Besides the central problem of the division of

powers and its corollaries of constitutional autonomy, judicial review and federal predominance, a federal state reveals other special features. Stipulations are generally made regarding the form of government in the states within the federation. The process of amending the constitution is made specially difficult. Secession from the federation is prohibited and a reconciliation is attempted between the allegiance of the people to their states and the federation. There are representatives in the federal legislature returned on state-basis in addition to the representatives elected by the people voting at large. The first chambers represent the people of the union as a whole, while the second chambers represent the states as equal partners in the union.

The second chambers are constituted in different ways. In Switzerland the members of the Conseil des Etats are elected by the legislatures of the several Cantons and naturally act as their delegates. In the United States and Australia the Senate is elected by popular vote, but each State has an equal representation in it. In the Australian Senate the representatives of the aggrieved States have always fought against a popular measure which might be injurious to the particular interests of their States.

In the United States the Senate represents the principle of the equality of the States in its composition and has worked on the basis of geographi-

cal groups as distinguished from the nation-wide political groups in the House of Representatives. This is evident from the proceedings of the 45th, 52nd, 54th, and the 64th Congress. An analysis of the votes of the 65th Congress shows that seven votes in the Senate relating to the liquor traffic, including the 18th amendment, would have been defeated, if popular representation had prevailed. Here the East was defeated by the West. The Senate bill taxing the products of child labour which the North wanted and the South did not was sent to the Finance Committee by the vote of the Southern States and was given the air of constitutionality, whereas the North desired the bill to go to the Interstate Commerce Committee which would have treated it as constitutional under the Commerce Clause. The individual States are seldom in evidence in the discussions of the Senate, but it nevertheless represents the principle of " sections " or geographical divisions of the United States, such as Middle States, South-East, South-West, the Mountain and the Plain States and the Pacific coast.

Under the Government of India Act of 1935 the Council of State in India shall be composed mainly of elected representatives from the Provinces and the delegates of the Indian States joining the Federation. The latter will be appointed by the governments of the States and will support the

point of view of their States, while members of the House of Assembly will represent the people of the Federation. Their membership of the Council virtually continues as long as they enjoy the confidence of their governments as against the membership of the representatives of the Provinces who are elected for a term of years. This system of delegates to the Federal legislature has, in fact, been criticised by the Minority Report of the Joint Committee on Indian Reforms (1934) as giving the representatives of the States "a fixity of tenure" as against the representatives of the Provinces.

Under the German constitution the States are represented in the Reichsrat through members of their governments who may send as many representatives as they have votes. These members are directly appointed and accredited by the State governments and are responsible to them. There has been a difference of opinion as to whether the States can bind their representatives by their instructions. The old constitution laid down that they were to follow the instructions of their States. The present constitution is silent about it and therefore Giese and others argue that as members of the Federal government they may speak and vote at their discretion. Würtemberg asserted the right of laying down instructions in the Hildebrand case, when it publicly reprimanded its representative, Hildebrand, a Social Democrat, who voted against

its instructions on party grounds. The matter is not, however, one in which the Federal government is concerned. It is, as Anschütz, Bilfinger and Held agree, a matter of domestic concern for each State. In actual practice a member can hardly afford to differ seriously from the minister or highest official representative of his State in the second chamber. The members of the governments speak in the Reichsrat in support of the attitude of their States regarding all important questions. The title of "ambassador extraordinary" (ausserordentlichen Gesandter) used by many of the States for their representatives denotes the nature of their representation.

§ 3. *The Field of Federal Activity*

The federal government is entrusted with the administration of subjects which are of common interest to the states forming the federation and which are best administered by the common authority. National defence is a federal subject and thus the army, the navy, and the air force, are administered by the federal government. The subject of foreign relations, with the power to declare war, make peace, and conclude treaties rests with the federal government. The diplomatic and the consular services and regulations regarding aliens, extradition, and migration are also federal subjects. Currency, coinage, reserve banks, posts,

telegraphs, telephones and wireless are also generally under federal administration as they affect all the states forming the federation.

The subjects reserved by the states are those which are more localised in character and are the immediate concern of the community forming a state. Agriculture, judicial and police administration, public health and sanitation and local government are subjects which are of immediate concern to the states and therefore are best administered by them. In certain other fields like education and communications the federal and state governments act concurrently. For purposes of uniformity or for general supervision, the federal government administers these subjects only to a certain extent, and where necessary supplements and subsidises the activity of the states.

The constitutional structure of the federal state determines the fields of the financial activities of the various governmental authorities. The government of a member state being concerned with the internal welfare of its community, does not, in general, collect or spend money for objects which relate to the welfare of the union as a whole. The federal government performs duties for the maximum common good for which the federation exists and its public finance sustains its operations.

On the analogy of the unitary state, public finance in a federation runs the machinery of the

state and helps towards the attainment of the objects for which the federation exists. It is concerned with the objects of the expenditure of the federal and the state authorities respectively, as also with the objects, proceeds and the modes of their taxation. It studies the effects of the expenditure and taxation of one authority on matters lying in the domain of another and on the economic life of the union as a whole. It examines questions of double taxation by rival authorities and those of the distribution of the burden of taxation.

"Most operations of public finance resolve themselves into a series of transfers of purchasing power."[1] Purchasing power in the form of revenue is transferred from individuals to public authorities, and it is re-transferred by public authorities in payment of services rendered or as social services for the common good. In a federation there are three authorities concerned in the transferences. Revenue is collected from the individual by the local, state and the federal governments. The revenue thus collected is often transferred in part by one to the other of these authorities before being finally spent. In a federal state, contributions from the states to the federal government and subsidies from the federal government to the states form important operations of public finance.

[1] Dr. Dalton: "Public Finance."

The question, therefore, again arises as to what constitutes the maximum common advantage of the union, and whether it is attained by bringing about uniformity of fortune among the states forming the union. The application of the "socialist" theory to federal finance, apart from being menacing to the bond of union itself, is beset with difficulties similar to those remarked in the case of a unitary state. The objects for which the member states hold together in the union can hardly be shown to imply a unification of fortune. It is, perhaps, just to develop and conserve its economic wealth better that a state accepts and pays for the federal government. Besides the difficulties in determining the position when equality can be said to have been reached, it is highly disputable whether greater common advantage results by levelling down the fortunes of the states, or, on the other hand, by permitting a state to utilise its wealth in consumption and in its own further development thus bringing about larger economic output. A state can very reasonably complain that a federal tax which falls on it more heavily than it does on another, not only deprives its people to a certain extent of satisfaction from its production, but also prevents a larger economic output which it can produce if it could employ the capital thus taken away.

Federal finance cannot, therefore, be considered

to assume the " socialist " mission. Its operations should essentially be based on the aims and objects for which the federation exists. However, where the interests of the union demand it, the poorer states or states in distress may be assisted to maintain satisfactory economic conditions by " progressive " taxation which falls more heavily on the richer states or by federal subsidies.

The problem of the nature of the financial activity of a state involves the consideration of the expenditure side as well as the revenue side of its operations. The effects produced by the tax system are modified by the expenditure of the state through its various beneficial services. It is thus the net result of the taxation and expenditure system that is important from the point of view of different classes of society and the community as a whole.

The size of the governmental operations in finance depends also on similar considerations. Public finance is considerably a smaller factor than private finance in the production, distribution and consumption of national wealth. What should constitute the limit of the financial activity of the state depends on the state of national economy in each country.

According to Professor Pigou, " if the community were literally a unitary being, with the government as its brain, expenditure should be pushed

forward in all directions up to the point at which satisfaction obtained from the last shilling expended, is equal to the satisfaction lost in respect of the last shilling called up on government service." But inasmuch as the government of a state does not control the entire economic life of the community, its operations should be supplementary to the activities of the community itself. Its revenue and expenditure programme should be no less and no more in size sufficient to achieve, in conjunction with private finance, " the best satisfaction of public needs, with a more abundant flow of national income." [1] The justification of a tax scheme and the test of propriety or wastage of public expenditure, depends on the question whether it contributes to the better enjoyment of national income taken out of the hands of private finance and whether it encourages the sufficient saving of national income for investment and further production.

The rôle of public finance should thus be the supplementing of the economic activity of the community. The nature and size of the financial activity of the government of a state should be determined by the ends sought by the community. In other words public finance should have no ends of its own.

[1] Professor Einaudi, quoted from Dr. Benham's " Notes on the pure theory of Public Finance." Economica, Nov., 1934.

A modern community directs the activities of its government towards an increase in its capital wealth to improve the methods and the size of its production of economic goods. It is possible, however, to conceive of a community which may not assign this mission to its government. This conforms with the concept of "neutrality" implied by Professor Einaudi in his examination of the merits of a tax: "The state must have no special, economic, moral, political or social axe to grind." As Dr. Benham interprets him, his neutral system of taxation and expenditure "is one which translates into effect the voluntary judgments and preferences of the citizens, whatever they may be." Nevertheless, under the ordinary ideals of a modern democratic society, it may be assumed that the activities of a community would be directed not only towards its own preservation and improvement, and the full enjoyment of its income, but also towards an increase in its productive capacity. Public finance should serve the community in its activities.

CHAPTER III

FINANCIAL COMPETENCE IN A FEDERATION

For the performance of their various functions the federal and the state governments require the necessary financial means. Political authority in a federal state or local government is incomplete without the power to collect and spend money for the objects of government.

In a federal state, governmental functions are divided on an autonomous basis between the centre and the states. It therefore follows that the federal government and the states should have sufficient independent provision of resources to perform the functions assigned to them respectively. If the resources are inadequate, the system will not work. Autonomy in the political field thus necessitates autonomy in the financial field. A distinction should, however, be made here between the power of taxation and the "proceeds" or the "objects" of taxation. When it is said that a government should have sufficient resources, a reference is not made to the "proceeds," that is, the amount collected by a tax, or to the "objects," that is, the subject matter of a tax. The reference

is to the power behind the tax and different governmental authorities in a federation should have this power sufficient for the proper discharge of their respective functions.

According to Dr. Hensel[1] the two alternate methods of assigning financial powers in a federation are: one of assigning exclusive financial sovereignty to either the bund or the states, and the other of admitting concurrent financial authority of both. Under the first alternative the impracticability of making the centre dependent on the states is illustrated by the crisis of 1786 in America. By the Articles of Confederation, it was laid down that congress could incur expenditure and borrow money for common defence or for general welfare. The expenditure was to be met not by taxation, but by a common treasury made up by the contribution of the several States. Congress frequently requisitioned the States to pay these contributions, but some States paid only a small part of what was asked and many ignored the demands altogether. The result was a complete breakdown of the administrative system in 1786.[2]

The "limited matricular system" in which the centre depends completely on the contributions of the units may suit a confederation and not a real federation. Like the German Bund of 1815,

[1] "Finanzausgleich in Bundesstaat."

[2] Dewey: "Financial History of the United States."

the measure of the dependence of the centre on the units indicates the measure of its weakness in performing functions of common interest. In the old German Empire again this weakness of the centre was noticeable. As Hensel puts it, " the political and financial sovereignty (Staatshoheit and Finanzhoheit) did not coincide in the German Empire between 1871-1914." It was in part due to the insufficiency of financial authority that during this period the imperial government lost and the States gained political authority. In Switzerland, again the Federal government has not had many expensive and important functions to perform. The financial resources at its disposal have thus been few. But the increase in its obligations during and after the War has forced the Federal government into the field of direct taxation. The high customs duties, the increase on the tax on petrol and the duty on sugar imposed in 1935 show that the financial powers of the Federal government are extending conformably to its political power and responsibilities.

Exclusive financial powers may be assigned to the centre and the units made dependent on it for financial means to perform the functions assigned to them. Such an arrangement suits a highly centralised state. It conflicts with the principle of autonomy of units underlying a federal organisation. It may not even suit a unitary state in which

the provinces enjoy a measure of local independence. The authors of the 1919 Reforms in India found such a subordination undesirable. Referring to the financial system which obtained under the Minto-Morlay Reforms (1909), they wrote: "If provincial autonomy is to mean anything real, clearly the Provinces must not be dependent on the Indian Government for the means of Provincial development. Existing settlements do indeed provide for ordinary growth of expenditure, but for any large and costly innovations Provincial governments depend on doles out of the Indian surplus."[1]

The other alternative method of disposing of financial powers is to distribute them between the centre and the units to be exercised concurrently. It is possible to assign these concurrent powers either by ordaining the two equally independent and autonomous, or by subordinating the units to the centre. The latter scheme is followed if the centre determines what contribution the units will make, and the units have to arrange for the collection and payment of this contribution. This "unlimited matricular system"[2] is more imperialistic in nature than federal. It errs on the

[1] Montagu-Chelmsford Report on Indian Reforms, 1919.

[2] "Contributions matriculaires sont proportionnées à leur richesse. Waitz declarait qu'un tel systeme bien qu'etant usite, etait contraire à la nature de l'Etat fédéral. c. a d. a sa propre doctrine sur les deux souverainetés separées." Ch. Durand: "Les Etats Fédéraux" (171).

centripetal side as the system of leaving the bund on the mercy of the states errs on the centrifugal side.

Under the 1919 Reforms in India a division of resources and obligations was made between the centre and the Provinces. It was found that the budget of the Government of India would show a deficit on the then existing scale of expenditure. A part of the increase in expenditure was due to the fall in the purchasing power of money. This fact was ignored, as also the possibility of an increase in the taxation of the Government of India. The Committee appointed with Lord Meston as president, to advise on the financial adjustment estimated that the resources of the Provinces, under the new scheme improved by Rs. 18.30 crores,[1] and so laid down that the Provinces should make certain specified contributions to the central government. During the seven years following 1921–22, the contributions as modified later were as shewn below:

Name of Provinces	*Year*						
	I	II	III	IV	V	VI	VII
Madras . .	35½	32½	29½	26½	23	20	17
Bombay . .	5½	7	8	9½	10½	12	13
Bengal . . .	6½	8½	10½	12½	15	17	19
United Provinces .	24½	23½	22½	21	20	19	18
Punjab . .	18	16½	15	13½	12	10½	9
Burma . . .	6½	6½	6½	6½	6½	6½	6½
Bihar of Orissa .	—	1½	3	5	7	8½	10
Control Provinces .	2	2½	3	3½	4	1½	5
Assam . . .	1½	1½	2	2	2	2	2½

[1] A crore is ten million.

These contributions were unpopular and incompatible with the feeling of autonomy in the Provinces, and by 1927–28 they were completely remitted.

The other scheme of concurrent financial powers would allow the federal and state governments equal independence within the spheres assigned. It is possible, under the scheme, either to distribute the " objects " (objekte) or the " proceeds " (ertrage) of taxation. The " objects " of taxation may be divided between the federal and the state governments and each authority may have full and exclusive powers to exploit the objects assigned to it. But if the division takes place with reference to the " proceeds," the " object " of taxation is controlled by one of the two authorities and its proceeds are shared by them in a definite proportion or by allocating a specified amount to one and the residue to the other.

Instances of such divisions may be noticed in the history of financial devolution in India. Under Lord Lytton in 1877, several civil departments, including stationery, printing, land revenue, excise, stamps, law and justice, and general administration, were transferred to the Provinces. For the administration of these departments, instead of a lump sum grant, a share was given to the Provinces in specified sources of revenue, which included excise, stamps, law and justice fees, proceeds of

the licence tax and some minor railway receipts. The rates of taxation were settled by the Imperial Government, but there existed a partnership—though unequal and indefinite—between the imperial and the Provincial Governments in the "proceeds" of these taxes. The revenue from these "divided heads" was to be taken in part by the Provincial Governments. But if they brought in any surplus over a figure specified for each Province, the Imperial Government was to receive one-half of the surplus.

As the total expenditure on the departments transferred to the Provincial Governments exceeded considerably the revenue assigned to them, the financial reforms of 1904 introduced the feature of "fixed cash assignments" under land revenue, the proceeds of which were divided between the provincial and the Imperial Government by assigning a block grant to the former and the residue to the latter. It was not until the settlement of 1911–12 that certain "objects" of taxation were exclusively given over to the Provinces with full powers of exploitation. According to the recommendations of the Decentralisation Commission, forest revenue and expenditure were completely provincialised. Land revenue and excise were also provincialised to a large extent.

Allied to financial power, that is the power of raising revenue, is the power to administer it.

Taxing powers and fiscal functions are counterparts of one another. The principle guiding the division of subjects for administration between the federal and the state governments has been noted above.[1] There are certain subjects essentially suited for administration from the centre, certain others essentially suited for administration by the units, while in certain others the two authorities together may advantageously perform assigned functions. Thus, all subjects of an international character, like defence, foreign relations and foreign commerce, and all internal matters which go beyond the boundary of one state in the federation, like inter-state commerce and communications, telegraphs and telephones, are of national importance and therefore administered by the federal government. For certain subjects, like education and agriculture, the provincial governments perform the main functions, while the federal government exercises a general supervision as regards policy and standards of administration.

The other branches of administration are left to the states, who in their turn share them with their local governments.

The division of fiscal functions between the federal and state governments, as indicated by the

[1] Chap II, Section 3: Field of federal activity.

departments under their administration, follows the line of the division of taxing powers. In general, as will be discussed later, some taxes are reserved exclusively for federal, and some others for state exploitation. In the matter of certain taxes both the authorities exercise powers. In this field statutory limitatons are imposed on their concurrent powers, while the economic limitations restrict the proceeds of one authority from such a tax in the case of an excessive exploitation of it by the other.

The subject of financial competence comprises also the power of raising money by loans and of launching and administering public commercial enterprises. The local, state and federal governments have in the past enjoyed powers regarding raising loans. There being no limitation on this power, questions arise regarding the extent to which loans may be raised for " productive " and " unproductive " purposes, the waste in administrative cost resulting from the competition of rival authorities to raise loans in the open market and the economic difficulties that may be created by a government borrowing without providing suitable means for its repayment. If left unchecked, an authority may pile up an avalanche of debts which may threaten the safe course of the economic life of the whole union. In recent years, therefore, the powers regarding public debt, though not

exclusively assigned to the federal authority, have been co-ordinated and supervised by a central agency.

The powers regarding commercial undertakings differ in different countries. In some countries, the administration of enterprise regarding transport, communication, power supply and irrigation is entrusted to boards organised on commercial basis, under one government or another, and their accounts are balanced separately in the budget. In the budgets of others, much distinction is not made between the revenue and expenditure of such undertakings and those of other government departments. In almost all federations, posts and telegraphs are under federal control. The co-ordinating and supervising power of the federal government has also been extending over railways, canals and airways. In India the central government has exclusive control over opium and salt, which are thus federal monopolies, in regard to which the Provinces have no financial powers.

PART II
Problems of Revenue

CHAPTER IV

PRINCIPLES OF FEDERAL TAXATION

THE various governments in a federation have powers of taxation assigned to them by the constitution. As has been discussed before there are several ways in which the powers of taxation have been distributed between the central government and the governments of the units. But there are underlying all these schemes of distribution certain broad principles. A federation is a union of equal partners. The central government has powers assigned to it for the common advantage of the members of the union. The principles underlying the distribution of taxing powers in a federation emanate from its special constitutional nature.

Uniformity

The powers of taxation in a federal state should be so exercised as not to favour one member-state at the expense of the other. The central government on the one hand should distribute its burden uniformly on all states and the states on the other hand should not discriminate between the citizens of their own and the other states. This is clearly

a rule dictated by the very nature of a federal state. The Australian Constitution, for example, lays down that " the Commonwealth shall not by any law or regulation of trade, commerce or revenue, give preference to one state or any part thereof over any other state or part thereof."

A federal law regarding taxation may not on the face of it have any provision for discrimination, but the burden of the taxation may fall more heavily on one than on the other states or may fall on some states only, leaving the others virtually exempt from it. These issues were raised in Flint *vs.* Stone Tracy Co.[1] in the United States. It was questioned whether a tax on tobacco was valid when many of the states do not grow any tobacco at all, and whether a tax on distilled spirits was uniform when a few states pay three-fourths of the whole revenue arising from it.

In such cases it is possible to provide for discrimination in the tax law itself in order that the ultimate incidence of the tax may be more uniform. This power to vary the rate of tax according to circumstances with a view to establish uniformity in incidence is not, however, generally conceded. It is hard to assess the differences in incidence and the power to discriminate, if too freely used, may lead to favouritism.

In King *vs.* Barger[2] in Australia the Excise

[1] 112 W.S. 580. [2] 6. C.L.R. 41 (1908).

Tariff of 1906 was held to discriminate between the various localities, because under it exemption from duty was granted according to the conditions obtaining in any particular locality. This was an attempt to modify or equalise the burden of taxation by varying the duty from place to place, but it was nevertheless held to break the rule of uniformity. A federal law should thus aim at geographical uniformity. It should tax similar objects at similar rates wherever they are found. A federal law taxing business carried on in corporate capacity and exempting that carried on by partnership is uniform as it operates with the same force in all states, although one of them may have more corporations than another. Again, a federal tax on legacies progressive according to amount and degree of relationship is uniform as the same degree of relationship or want of relationship to the deceased, wherever existing, is levied on at the same rate, although different conditions may obtain in different states as to the objects upon which the tax is levied.[1]

The point of view of individual states, in such cases, should not be allowed to complicate the smooth working of a federal tax law. The country covered by the federation must be regarded as a whole. The federal authority should be expected to guard against any case of gross

[1] Knowlton *v.* Moore.

injustice arising under the rule of geographical uniformity.

Considering the federation as an economic unit, the federal government is justified in giving relief to backward regions or states in need of help in the form of subsidy, though not through discrimination in its imposts. The speed of the navy is the speed of the slowest boat in it. Any particular state, which, in spite of its efforts, remains far below the economic level of the federation, stands clearly in need of common assistance to enable it to afford to its citizens the standard of life prevailing over the country. From this point of view it is necessary to see that the membership of the union is based on sound "economic" qualifications. The units of the federation should be able to work as autonomous groups and none of them should be intrinsically unable to live on its own. A region which can remain autonomous only as a chronic parasite on the whole country should not be left over to itself, but should be absorbed to improve the economic organisation of the country. During the discussions at the Round Table Conferences on Indian Reforms, this point of view was emphasised by Mr. Ambedkar when he criticised the inclusion as member-states in the Indian Federation of tiny principalities "which can be crossed in an hour in a motor car." The size of a principality may be so small and uneconomic and its revenues so meagre

that it will be a waste for it to have to maintain a complete duplicate of the administrative machinery of a fully organised state with its various departments and the heirarchy of their officials. If the administration is not properly paid for, it is bound to become inefficient. Treaty obligations and guarantees to preserve the integrity of even these very small States make it impossible, however, to approach the question of absorption under ordinary circumstances. Similar economic considerations have afforded one of the arguments against the "New State" movement in Australia. Three times during the past ten years Royal Commissions have considered proposals to create new States. Most of the grievances upon which the "New State" movement was fostered concern the government of New South Wales. There is every reason to believe that the development undertaken by the New States would duplicate the existing transport, shipping and warehouse facilities for handling goods and products. Much of the public and private capital equipment would be laid idle, resulting in an increased burden upon taxpayers and producers. This would be reflected in reduced revenues for the State and Federal governments, and instead of establishing a proper balance would tend to make conditions worse all round. The two proposed new States and the residual States of New South Wales would be

added to the existing number dependent upon special subsidies from the Commonwealth Treasury.[1]

The rule of uniformity in taxation requires also that a state should not discriminate between its own citizens and those of the other member-states. The constitution of the United States expressly provides against it. Article IV, Section 2, lays down that "the citizens of each State shall be entitled to all the privileges and immunities of citizens in the several States." Corporations, however, are not included under this rule, and a State is at liberty to tax foreign corporations doing business within its territories at a higher rate than that applicable to domestic corporations. Unequal taxation as between the citizens of the state and the citizens of other member-states is, therefore, to be avoided in a federal organisation. In the Indian Federation there will remain a discrepancy in this respect if those Indian States,[2] which levy no income tax at all on persons or corporations, do not concede the subject of income tax as Federal in their Instruments of Accession. Citizens and corporations belonging to other parts will be less

[1] An interesting discussion on the New States problem is found in Circular No. 5 of the Bank of New South Wales on: "The Problem of the Australian Constitution." October, 1935.

[2] Hyderabad, the largest Indian State levies no income tax.

heavily taxed in such States than elsewhere, and citizens and corporations of these States will be more heavily taxed elsewhere under the Federal law than within their territories.

Freedom of Inter-State Commerce

One of the predominant motives for states in ancient times to draw close together has been the formation of a common customs union. The German " Zollverein " was an association of states observing uniform rules of customs duties. In such a union inter-state commerce has no impediments. In a federation, which is a much closer and integral organisation of states, it is evident that in the interests of common economic development trade between the member states should be free from varying transit duties like customs, octrois, and tolls.

This freedom of inter-state commerce is generally secured by entrusting the federal government with all powers regarding import and export duties. Under the United States constitution the Federal government has not only the powers of taxation of inter-state commerce, but has utilised its authority under the " commerce clause " to control matters of a non-fiscal character, in intra-state as well as inter-state commerce. There exist a few departures from this rule which only show the necessity of the freedom of internal commerce for

the economic welfare of the federation as a whole. The South African Colonies had varying duties on inter-state commerce, which resulted in friction and economic waste.[1] According to the Constitution of Brazil, the States have the right to impose export duties. The exercise of this right has always resulted in raising up tariff barriers within the country, harmful to the development of internal and external trade. In India, some Indian States have no access to the sea at all, while they have a right to impose, within certain limits, customs duties on imports to and exports from their territories. Foreign goods coming in their territories from ports in British India are taxed by the central government. They have had no share in the assessment, collection or use of these sea customs. There have been complaints that sea customs have various adverse effects on the commerce and industry of these States. One of the dangers to be guarded against is the jealousy with which sea customs are regarded by the States, and the possibility of their re-acting to sea customs by utilising their right to impose customs at their own frontiers.

The Extent of the Taxing Power

The taxing power assigned to the various governmental authorities in a federation is plenary and unrestricted. The subject matter of the tax may

[1] The Selbourne Memorandum (1908).

be limited in various ways, but the power to tax the subject matter so assigned is unlimited. This principle does not apply to non-tax laws, even though revenue may accrue through their administration. Legislative acts relating to the power of eminent domain, and police powers regarding the grant of licences and imposition of penalties should be distinguished from tax laws, which are essential to the " very existence of government, and may be exercised on the objects to which it is applicable to the utmost extent to which the government chooses to carry it." [1]

The taxing power is, however, employed by governments in many cases for other purposes than mere revenue. It is used for prohibiting imports of certain articles, for encouraging domestic industries and agriculture, for protecting local products, for retaliating against foreign monopolies and restrictions, for suppressing particular products or employment and for destroying competition and establishing a virtual monopoly for government where necessary. This authority may be used without restriction, and in the words of Chief Justice Marshall: " The power to tax involves the power to destroy."

Any misuse of this power is avoided by express agreements between the governments whose interests may clash or by provisions traceable

[1] McCulloch *v.* Maryland W.S. 4. Wh. 316.

in the original constitution. In the United States the Federal government is required to apportion its tax among the States according to the number of their several inhabitants. This condition has practically deprived the Federal government of the power of direct taxation except income tax.

In the absence of any such conditions or agreements the only check which can be exercised on the use of this plenary power by a governmental authority is the jealous guard over any encroachment on subject matter lying within the competence of another authority. This is the task of the courts in a federation who will decide as to the validity of a legislative act of an authority with reference to the division of powers in the federal scheme. The plenitude of the taxing power of the several governmental authorities in a federation, and its limitation with reference to the subject matter of the tax are results of the special constitutional nature of the federal state.

When Congress laid a prohibitive tax on State banknotes in America in order to protect the newly established Federal banks against the competition of the State banks, the tax was held by the Supreme Court as valid. It was the proper exercise of the power to regulate currency assigned to Congress by the United States Constitution. But a tax on employers "knowingly" employing child labour was held to be unconstitutional as it was an

encroachment on the power of the States regarding factory legislation.

In India the Federal government is given plenary powers as regards the Federal Legislative List. With regard to subjects in the Concurrent Legislative List the Federal law will override the law of the Province. But the Indian States have plenary powers regarding all subjects other than those which they accept as Federal. It is, therefore, possible that in the matter of insurance, trade unions or labour disputes (Concurrent List) the laws of a State will come in conflict with a Federal law on the subject. The possibility of friction under such matters may be avoided by special agreements or by the States adopting the Federal law within their territories.

The taxing power is in many cases, by common consent, not exercised on the properties and agencies of the several governments in a federation. Such immunity from taxation is mutually granted in order that one authority may not hamper the activities of the other. But there are certain considerations which make the wholesale application of this principle difficult. It is hard to lay down "where the instrumentalities of a public authority begin and end."[1] In Abbott *v.* City of St. John[2] in Canada, it was held that there

[1] Professor Adarkar: "Principles and Problems of Federal Finance."

[2] 40 S.C.R. 597.

was no conflict between the Federal and the Provincial governments when Federal officers performing their duties in a Province are required to pay income tax to the Province. A conflict would arise if either authority resorted to discriminatory or confiscatory taxation to handicap the agency of the other. In The Attorney-General for New South Wales *v.* The Collector of Customs, New South Wales claimed exemption from Federal customs on steel rails imported for the construction of State railways. The claim was turned down as it was held that in such cases the States could by excessive importation of different kinds of materials defeat the objects of the regulations and deprive the Federal government of a large portion of its customs revenue. In such cases it is possible, however, to make a distinction between the property held by a state for governmental purposes, and that held for its commercial enterprises.

In Australia the immunity of instrumentalities does not exist any more. Only the property of the several governments is exempt from taxation. In the United States and in Brazil both the properties and the agencies of the federal and state authorities are exempt from taxation by each other. Thus the federal banks, federal securities and federal officials are exempt from state taxation.

Independence and Responsibility

The fiscal powers in a federation should be so distributed among the several governmental authorities that each one must feel sufficient freedom to plan and carry out its administration and schemes of development. Each authority should feel reasonably confident that in the legislation, assessment, administration and use of its revenue, it will not be disturbed. In the absence of such confidence, it is impossible to make useful plans ahead and carry them out with economy.

This, however, does not mean that the system should be one of watertight compartments. Considering the federation as a whole, it is sometimes necessary for one group to help the other. The financial organisation in a federation should be essentially based on the principle of independence, but should provide for means to balance and poise serious ups and downs in the system by reciprocal action. It should provide for removing marginal surpluses of one authority if it is required to meet the marginal deficiencies of the others. For this purpose various methods of sharing the proceeds of certain taxes, subsidies and subventions have been resorted to. A discussion of these is found in a later chapter.

The device of grants and subsidies may often be carried so far as to defeat the principle of independence. The subsidies in Canada and the

Australian subventions under the Federal Roads Act, for example, made the recipient authorities feel dependent and secure. Certainty and facility in obtaining its revenues may lead a government to extravagance. It will not forget the need for economy when it feels the responsibility to find the means to raise the money it wishes to spend. Hence grants, aids, and subventions should be restricted to cases of real need, while each government in the federal system remains responsible for raising its revenues and is independent to utilise it.

The useful working of the principle of independence and responsibility in fiscal affairs is illustrated by the working of the various government departments in the State of Hyderabad, under the scheme of the Departmentalisation of Finances instituted by Sir Akbar Hydari. Under this scheme, which has now been successfully worked for several years, each department of government is left independent to retain the annual savings for three years. As the savings do not lapse to general revenue, the departments can take a long view of their activities and abstain from hurried and extravagant expenditure to consume the grant of the year within the year. At the end of three years, which is the period of the fiscal contract, one-half of the savings of each department lapses to government, the other half being available for the department itself. The

department, as a rule, is also allowed to utilise any excess that it may bring about in its receipts. Sir Akbar Hydari's scheme has thus imparted to the spending and collecting departments a sense of independence and responsibility which has promoted confidence in their administration and projects of development, and brought about economy in their expenditure.[1]

Adequacy and Elasticity

The fiscal powers allotted to the federal and state governments must be sufficient for their respective needs at present, and for possible expansion of their expenditure in future. If the resources assigned to an authority are inadequate, it will lag behind economically or will have to be perpetually dragged along by the aid of others. The inadequacy of the resources of the common authority was the cause of the breakdown of the confederal system in America. The Federal government in Switzerland does not enjoy means sufficient to meet the increase in its obligations and functions which post-war conditions have brought about. The need for the expansion of its resources has been recognised and the much-debated taxes on benzine and sugar imposed last year are instances by which

[1] The detailed regulations of the scheme of the Departmentalisation of Finances are compiled by the writer in the Hyderabad Financial Code.

it is enlarging its resources. In Canada and India the resources at the disposal of the Provinces are inadequate to the economic and cultural development that lies ahead of them.

From the point of view of elasticity, certain taxes, like income tax and customs, are intrinsically capable of yielding more revenue than others. There are three considerations which affect the elasticity in such cases. Firstly, the further yield from a tax depends on how far it has already been utilised. If the rates of the tax have been high, they may not with advantage be raised much higher. Secondly, in the case of certain commodity taxes, an increased rate may force a change in people's habits and fashions and through a smaller consumption of that commodity decrease the tax revenue. Lastly, the elasticity of the tax may be considerably limited if two authorities enjoy and exercise similar powers in respect of the tax. If the scales of tax are raised by one, the yield from the tax for the other does not remain as elastic as before.

Administrative Economy and Efficiency

A tax scheme, however just and proper, should be practical if it is to be successful. It should be able to be administered with economy and efficiency. The federal authority is better suited than state authorities to assess and collect certain

taxes, while the management of certain other taxes by the federal instead of the state authority would lead to fraud, leakage, evasion and increased cost of administration. The extent of economy that may be effected in suitable cases is indicated by the remark of the Commonwealth Treasurer at the Ministerial Conference (1919) in Australia, when he declared that the whole direct taxation of the States could be collected by the Federal machinery at one-third of the cost incurred by the States.

Taxes on real property can be better administered by state or local authorities as they have the necessary local knowledge, experience and contact for proper management. Direct local administration in such cases also suppresses fraud and evasion, which a central authority with its distant headquarters and a tedious official routine will find it hard to prevent.

Customs duties, inheritance and corporation taxes, on the other hand, lend themselves to be better administered by the federal authority and form its sources of revenue. If the subject matter of a tax has an inter-state significance, it is the central government which can supervise and collect the tax over the borders of more than one state. A business, for example, which is spread over the whole country may earn various amounts and profits in different states. It is the federal

authority which is best suited to assess and collect the tax on the income of such a business according to the rates applicable to the aggregate of its earnings.

When the subject matter of a tax is spread over several states, it is expedient to entrust the administration of the tax to the central authority in order to avoid conflicts of jurisdiction between two states and double taxation by rival authorities. In such cases evasion and fraud through escape from one to another jurisdiction is rendered impossible. From the point of view of the taxpayers, complexity in modes of payment and diversity in forms and procedure is avoided. Moreover, when the central authority administers a tax it can be made progressive in an effective manner all over the country.

It is for reasons of administrative economy and efficiency that stamp revenue is assessed by the Central government in India, but collected by the Provincial governments. A division of proceeds is made between the Central and Provincial governments on the basis of the various purposes for which stamps are used. Under the India Act, 1935, income tax is a Federal subject for administration, but its proceeds will be shared by the Federal and Provincial governments.[1]

Under the constitution of 1871 and the Tariff

[1] Article 138 India Act, 1935.

Law of 1879, the States in Germany collected the tariffs and the tobacco duties through their own machinery and credited to the Imperial government its share of the revenue.

CHAPTER V

ALLOCATION OF RESOURCES

A STUDY of the schemes adopted for the allocation of the subjects of taxation in the various federations, shows that generally it was intended to carry out the division on the basis of direct and indirect taxation. The federal government is better suited to administer indirect taxes which were, therefore, marked out as its sources of revenue, while direct taxes were reserved to the states. But there is an inherent defect in such a division, because in times of war or crisis, the revenue from customs would diminish considerably and other indirect taxes on internal consumption will hardly bring in enough to meet the normal needs of the federal government. It will have to resort to other means to pay for the ordinary cost of its administration and to incur the heavy expenditure necessary in such emergencies. In normal times, the federal government may tend to adopt a policy of unnecessary protectionism if customs were its sole source of revenue.

The actual position, therefore, in the several federal states is far from being restricted to this

distinction between direct and indirect taxation. In the United States, Congress has power to levy and collect taxes and imposts, to pay for the debts and provide for the defence and welfare of the union.[1] The power of the Federal government to levy a direct tax is limited by the clause that "no capitation or other direct tax shall be laid unless in proportion to the census or enumeration hereintofore directed to be taken." This made it practically impossible for the Federal government to levy direct taxes. But to enable it to meet its growing obligations, the 16th Amendment has permitted the Federal government to levy taxes on incomes "from whatever sources derived, without apportionment among the several States, and without regard to any census or enumeration." This has placed income tax in the United States in the concurrent field of legislation. The judges now apply the term direct tax in its narrow sense to poll tax or property tax.

The Federal government thus has powers of indirect taxation, including customs and levies direct tax or incomes. This places the corporation and inheritance tax under its jurisdiction concurrent with that of the States.[2]

[1] Article 1, sections 8 and 9 of the Constitution.

[2] The Corporation income tax in 1930 accounted for 34.9 per cent., the personal income tax for 31.6 per cent.; customs duties 16.1 per cent., and the tobacco excise for 12.5 per cent.

The States have the residual powers in finance, excepting the powers expressly prohibited to them by the Constitution, like customs or transit duties under the inter-state commerce clause. Property and poll taxes are their exclusive sources of revenue. The Federal government cannot exploit them, as they are direct taxes and cannot be "apportioned." However, as Professor Seligman points out,[1] the general property tax has been found to be defective owing to its lack of uniformity, failure to reach personal property, incentive to dishonesty, regressiveness, and double taxation. Pennsylvania and North Carolina have abandoned property taxation. The States have now developed a large tax revenue from highway taxes, that is, the duties on motor vehicle licence and motor vehicle fuel. The yield from these taxes has exceeded that from the property taxes.

The States have also, during the period of prohibition increased their revenue from business taxes. But as the system of assessment and collection of the income and corporation taxes differs from State to State and as the Federal Government also has concurrent powers with regard to these and inheritance taxes, there occurs a double or sometimes a multiple taxation of the

of the Federal tax revenue. Schultz: "American Public Finance and Taxation."

[1] Essays in Taxation: Chap. II.

same object.[1] After the repeal of the Eighteenth Amendment, liquor and licence taxes have again become an important source of revenue for the States.

In Germany, the Constitution of 1871 gave the Reich four sources of revenue: exclusive customs duties, consumption taxes, postal and telegraph receipts and State contributions. Imperial charges "in so far as they could be provided by other revenues were to be met, as long as Imperial taxes were not introduced, by contributions from the single States of the confederation in proportion to their population, which contributions were to be assessed by the chancellor of the Empire" (Article 70). The Reich had also the sole power to tax salt, tobacco, beer, spirits, and sugar syrup, subject to the proviso that Bavaria, Würtemberg and Baden were to retain their power of taxing native spirit and beer within their own territories (Article 35). The Constitution also provided that "taxes to be used for the purpose of the Reich were to be supervised by the Reich." The draft of the constitution had proposed this provision to apply to indirect taxes, but the word "indirect" was deleted afterwards. The States, however, insisted that the provision in Article 70 that "as far as the Reich could not obtain its

[1] Double taxation by rival authorities is discussed in the next chapter.

means otherwise it could levy contributions on States," made direct taxation permissible only in emergencies. There following a long struggle between the Reich and the states, the latter attempting to curtail the taxing powers of the Reich. But the Reich ultimately succeeded in introducing direct taxes in various forms.

By the Tariff Law of 1879 the Reich began to assign the proceeds of tariffs and the tobacco tax in excess of 130 million marks to the several States in proportion to their populations. In 1881 and 1894, the Reich stamp duties and brandy duties were added to the two taxes subject to the assignment plan. The proceeds of these taxes were shared in conjunction with a system of subsidies from the States on a *per capita* basis. But as the increasing needs of the Reich made it necessary to increase taxation, the Imperial inheritance tax was introduced, which marked the entry of the Reich into the field of direct taxation. In 1909 an additional revenue of 500 million marks was raised by increasing the States contributions, by reducing the share of the States in the Reich inheritance tax from one-third to one-fourth, by raising the scales of the indirect taxes and by levying a tax on the unearned increment of land.

The Weimar Constitution lays down that " the Reich has legislative power as regards taxes and other sources of revenue, in so far as they are

claimed wholly or in part for Federal purposes. When the Reich demands taxes or other sources of revenue hitherto appertaining to the various Länder it must take into consideration the maintenance of the vitality of the Länder." The Reich may also "draw up regulations regarding the admissibility and mode of collection of the Länder's taxes, in order to prevent (*a*) damage to the revenue or the commercial relations of the Federation, (*b*) double taxation, (*c*) charges for the use of public communications and their accessories which are excessive and impede traffic, (*d*) tax discrimination against imported goods as opposed to home products, in commerce between the individual States or parts of States, (*e*) export bounties, or (*f*) for the protection of important social interests."

The Reich, therefore, can oust the States from any field of taxation by simple legislation. No States tax which is injurious to a Reich tax is valid. The chief taxes levied by the Reich are income and inheritance taxes, the corporation tax, customs, tax on commercial transactions and tobacco, sugar and spirit monopoly tax. The States share a proportion of these taxes, as decided by the Reich from time to time. Under the pressure of the Reparations, the Reich expanded its programme of taxes to meet the requirement of the Treaty of Versailles that "the taxation in

Germany should be as heavy proportionately as that of any of the foremost states." In 1922 eighteen new taxes on property and incomes and on consumption were levied, but the States were assigned a portion of the return of these taxes. In 1924, the year of the Popitz Reform, bringing the finances into line with the new stabilised currency, the States received 2,744 million marks out of a total revenue of 7,973 million marks.

The States do not feel sufficiently independent as regards their resources. Their own tax system may be disturbed at any time by a tax law of the Reich. Their share in the Reich taxes may vary from time to time, as it is the Reich which determines the scales of these taxes and the proportion due to the States. The system of grants thus remains a necessary evil in Germany. The States receive large assignments from the Reich and thus do not attain the position of independence and responsibility so essential to any scheme of federal finance. In 1934–35 the States received 540 million marks as assignments, in addition to their share in the Federal taxes. There exists in Germany a system of centralisation in financial administration.[1] But this does not necessarily involve centralisation in financial competence which may run counter to the very principle of autonomy in the federation.

[1] This is discussed in a later chapter.

In Switzerland the sources of Federal revenue are the yield of the Federal domain, the Federal customs duties, posts and telegraphs, the powder monopoly, a half of the tax on exemption from military service and cantonal contributions. The entire proceeds of the Federal alcohol monopoly (amounting to 6,110,000 francs in 1933) are divided among the Cantons and they have to spend one-tenth of the amount received in combating alcoholism. The constitution originally reserved the power of direct taxation to the Cantons. But owing to the increase in the obligations of the Federal authority, its resources have been gradually enlarged. A practically unanimous vote of the people in 1915 permitted the Federal government to levy a direct tax on incomes and property. In 1917 the Federal government acquired the right to levy stamp duties on securities, insurance premiums, bills of exchange, cheques, coupons and other commercial papers excluding those relating to real estate transactions. In 1935 a tax was imposed on sugar and the scale of tax on benzine was increased.

The revenue of the Cantons is derived mainly from taxes on income and property and on production and transactions, which yield nearly two-thirds of the total tax revenue. The other taxes levied by the Cantons are death duties, taxes on gifts *inter vivos* and taxes on motor cars and

carriages. The Cantons have capital resources, commercial enterprises and property of their own, from which they derive a large annual income. They receive subventions from the Federal authority, while the Federal right to levy contributions from them has been obsolete since 1849. Thus it is the Federal government which stands in need of enlarging its resources to meet its increasing responsibilities, as the field of direct taxation is still almost completely reserved to the Cantons.

In Canada, section 91 of the British North America Act confers upon the Dominion Government the power of "raising money by any mode or system of taxation." The Provinces have the power of direct taxation within their respective territories and of levying fees on shop, saloon, tavern, auctioneer and other licences in order to raise a revenue for provincial, local, or municipal purposes.

The power granted to the Dominion is broad and inclusive of every sort of taxation, while the power granted to the Provinces is definitely limited in area and kind. There is no conflict between these powers. Each power is the necessary adjunct of mutually independent governments and the distinction is one of purpose, not of kind.[1] In Bank of

[1] Kennedy and Wells: "The Law of the Taxing Power in Canada."

Toronto *v.* Lambe, the Judicial Committee of the Privy Council decided that "as regards direct taxation within the Province to raise revenue for Provincial purposes, the subject falls wholly within the jurisdiction of the Provincial legislatures." But the power of the Dominion being larger and inclusive, there is the possibility of double taxation, if the tax is of a kind to be found within the area of the Provincial as well as the Dominion taxing powers. In Ontario, for example, the Province, through authority granted to certain municipalities, imposes a direct tax, which falls on the objects on which an income tax is levied by the Dominion Government.

The main sources of tax revenue for the Dominion Government are customs, excise and the sales tax, which account for 80 per cent. of the revenue from taxes. It would appear that the tax system of the Dominion is extremely regressive, as customs, excise, and the sales taxes fall more heavily on the incomes of the poorer sections of the community. But the fiscal system of the central, provincial and local bodies must be considered as a whole. Besides the income tax levied by the Dominion, the Provinces and the municipalities impose considerable taxes on property, income, corporations, and inheritances.

Dominion subsidies have diminished in importance as sources of Provincial revenue and as

the Provinces now raise considerable revenues by direct taxation, it is advisable to limit the powers of the Dominion regarding income and corporation taxes. This question was raised in the Dominion–Provincial Conference of 1927. The field of income tax can, with advantage, be divided between the two sets of authorities. The tax on personal incomes can be assigned to the Provinces and that on corporations, being essentially inter-provincial in nature, can be exclusively given to the Dominion Government.

In Australia, Section 51 of the Commonwealth Act grants the Commonwealth Government full powers of taxation, subject to the limitations of reciprocal immunity of governmental properties and non-discrimination between states or parts of states. Customs and excise taxes, post office, currency and a few other items are exclusively reserved for the Commonwealth Government. In other fields the States have powers of taxation concurrent with the Commonwealth Government. Before the federation, the States derived a large revenue from customs and excise. To compensate them for this loss the Constitution provided for them initially for ten years a system in which they shared the proceeds of these taxes with the Commonwealth Government. The Financial Act of 1910 altered this arrangement by laying down that the Commonwealth Government should pay

25s. per head of population to the States for ten years " and thereafter until parliament otherwise provides."

The Commonwealth Government imposed succession duties in 1914 and an income tax in 1915, followed up by taxes on war profits and entertainments. In 1927 the State Grants Act abolished the *per capita* subsidies and the Financial Agreement of the same year provided for the taking over of the State debts by the Commonwealth and for the control of the debt operations in future by the Australian Governments acting together through a Loan Council. In 1930 a further direct tax of 2½ per cent. on sales was imposed by the Commonwealth which was later raised to 6 per cent.

The main taxes levied by the States are probate, and succession duties, stamp duties, land tax, income and dividend tax, liquor and other licences, racing taxes and motor vehicles taxes. The tax scheme of the States is highly progressive. The income and dividend taxes bring in nearly a half of the total revenue of the States, while the motor tax, which also has a greater incidence on the richer sections of the community, is growing in its yield.

Under the Government of India Act, 1935, the sources of revenue for the Federal government in India are customs, railways, coinage and currency, excise on tobacco, corporation tax, salt tax, taxes

on incomes other than agricultural incomes and taxes in respect of succession to property other than agricultural land. The heads of tax revenue assigned to the Provinces are excise on alcoholic liquors, opium and drugs, taxes on agricultural incomes, taxes on lands and buildings, duties in respect of succession to agricultural land, taxes on mineral rights, capitation taxes, and tolls and taxes on professions, trades, luxuries and amusements.

The Federal income tax will be shared by the Federal government and the Provinces on the basis of a certain percentage fixed by His Majesty in Council. The Federal corporation tax shall not be leviable in any State until ten years have elapsed from the establishment of the federation. The States, who do not enter the Federal income tax, shall not in this respect contribute equally with the Provinces towards federal burdens, though they shall be required to pay an estimated amount towards the supercharge that may be imposed by the Federal government for its purposes on the Federal income tax. An attempt has been made to equalise the benefits and burdens of the federation between the Provinces and the States by assigning cash values to the reciprocal guarantees and privileges enjoyed by the Government of India and the respective States, and by determining the net obligations on the basis of a balance of such cash

values.[1] The tax scheme of the Federation as a whole, however, is far from being uniform, not only because certain State members of the Federation do not levy taxes on incomes but also on account of their indigenous customs tariffs.[2] As contrasted with the Provinces, their taxation will tend to be more regressive. The Federal customs coupled with State customs will increase indirect taxation which will fall more heavily on the poorer sections of the community in those territories, while there will be no element of progression in their tax scheme owing to the absence of a tax on incomes.

The details of the allocation of resources in the various federal systems reveal that the old distinction of direct and indirect taxation does not remain

[1] See the Reports of the Federal Finance Committee (Percy Committee), 1932, and the Indian States Enquiry (Financial) Committee (Davidson Committee), 1933. See also sections 145–149, Government of India Act, 1935.

[2] The position of the customs tariffs of the States is analysed thus by the Peel Committee: "It may be impossible for the States to surrender, either immediately or in the near future, large sources of revenue without the acquisition of fresh sources, nor would it seem in general an equitable plan for the Federation of attempt to buy up, so to speak, the existing rights of the States in such a matter. This would simply mean that in the general interest of economic unity and to facilitate trade, a tax would be imposed on the Federations as a whole, in order to relieve the inhabitants of the States. The abolition of these taxes must, therefore, be left to the discretion of the States to be effected in course of time as alternative sources of revenue become available."

the guiding principle of the division of taxing powers between the federal and the state governments. The issue from the point of view of suitability is whether the basis of a given tax is wide or narrow. In proportion as the basis of a tax is more and more extensive, the reason for its being utilised by the wider rational jurisdiction becomes correspondingly strong. The tax on real estate, for example, is generally assigned to state governments as its basis is narrow. Commodities of general consumption have a very wide basis and are, therefore, objects of taxation generally reserved for the federal governments. The same is true of customs duties, taxes on incomes, corporations and inheritances.

From the point of view of adequacy, however, the federal nature of the taxes on incomes, corporations and inheritances may not be defended so strongly. The general property tax has been one of the main sources of the revenue of the states. But in modern times it is being given over to local authorities, as it has a very narrow basis and has proved defective as a tax handle for the states. Consequently the states have been compelled to find new sources of revenue. In several of the States in America the property tax has been completely given up, and the corresponding revenue is now found mainly from the inheritance and corporation taxes. An assumption of these taxes

by the Federal government may be justified from the point of view of the wide and national basis of these taxes. But it would leave the States with inadequate revenues. The federal administration of an income tax, however, may be reasonably defended. If the tax scheme of the country is to remain on a progressive basis, the central government should derive its revenue from a tax on incomes as well as from indirect taxes, which generally tend to be regressive. An income tax can be more effectively and uniformly progressive all over the country, if it is administered by the central authority instead of the governments of the units separately. From this point of view it is hard to agree with Professor Seligman when he says: "That a national income tax is not needed for revenue purposes."[1] To counteract the regressive effect of customs duties and indirect taxes, a certain part of the revenues of the federal government should be raised from a tax on incomes.

Indirect taxes and customs duties have invariably fallen within the federal field of taxation for reasons of suitability and adequacy. Income, corporation and inheritance taxes, however, belong to the federal field from the point of view of suitability, but may not be assigned wholly to the Federal government, if the states are to have adequate resources. They may thus be adminis-

[1] Essays in Taxation.

tered by the federal authority and their proceeds should be shared by it with the states. They remain, however, subjects of concurrent taxation as in Australia and Canada. The Constitution of India presents an improvement in this respect as the corporation tax and the income tax are Federal subjects and the proceeds of the income tax are to be shared by the Federal and the Provincial governments. The inheritance tax is split up. Taxes on succession to agricultural property are assigned to the Provinces, while the Federal government reserves the taxes on other inheritances.

CHAPTER VI

INCIDENCE OF TAXATION

Distribution of the Burden of the Federal Taxes

In a country under federal government, the tax system deserves study from the point of view of the distribution of its burden among the various states forming the federation. The member states differ from each other in size, natural wealth, population, geographical position, nature of their industries and the stage of their economic development. It has been discussed before that in imposing a tax it is impossible for the federal government to achieve material uniformity of incidence, and that what it should aim at is geographical uniformity, in taxing similar objects at similar rates all over the country.

It is, however, possible that in spite of its formal equality of treatment, a federal tax may fall wholly or in a large measure on some states, leaving the others practically free from its burden. The customs tariff in Australia has, instead of promoting uniform development throughout the country and fostering a sense of solidarity and mutual inter-dependence, served to create a gulf

between the States by aggravating, if not inducing, a conflict between primary and secondary industries on the one hand, and between those industries which are sheltered and those which are unsheltered, on the other. Melbourne and Sydney have enormously developed secondary industries and have thrived from favourable tariffs. The unequal effects of the tariff are seen in the distribution of population and the consequent apportionment of political authority in the federal legislature. The cities of Sydney and Melbourne return 24 members to the House of Representatives out of a total of 75, while the States of Tasmania and Western Australia each send 5 members.

The disabilities of the primary producing States in Australia are again increased by the Federal Navigation Act. Tasmania is an island state and has grown to depend to a large extent on its tourist traffic. South Australia must import timber and coal. Western Australia has a large coastline with little inland railway development. These States need cheap and frequent shipping services and hence the Navigation Act strikes them harder than it does the other states, which can rely on their highly developed railway systems.

In India the States have similar grievances under the Federal scheme of taxation. The revenue collected through the various Federal taxes from States will go to defray the expenditure of the

Federal government, which includes debt services and pensions, subventions to Provinces suffering deficits, defence services and civil administration and works.

The States have not been responsible for the Public Debt of British India. The propriety of their sharing this burden and bearing the cost of the service of the Public Debt is discussed in a later chapter. There may be no objections to their bearing the cost of subventions to Provinces in need, under a scheme of mutual assistance. The proper proportion of the expenditure on civil administration and works has obviously to be shared by the several units of the Federation.

As regards normal defence expenditure, which is nearly 60 per cent. of the total expenditure of the Central government, the States have a different point of view. The object of the treaties entered into between the British Government in India and the States was to establish peace in the country and to render mutual assistance at a time when internal wars and insecurity prevailed in the country.

As a general rule the British Government guaranteed the States assistance in case of internal disorder and protection from outside aggression, in return for their alliances and undertakings not to have diplomatic relations with foreign powers. A few States ceded extensive territories to the

British Government as the cost of their defence. Many of them maintain large armies at considerable cost for Imperial defence. Federal revenue collected from the States for this purpose is, therefore, regarded by them as an extra burden laid on them, unless they receive compensation in some other form.

The rule of what may be called "justice" in the incidence of a federal tax among the several states is hard to find. The states gifted by natural wealth can pay more than the states suffering from natural poverty. Certain states again enjoy greater benefits from the union than certain others, and would pay more under the "benefit" principle. Some states have attained a sufficiently high standard of economic development than some others. Contribution towards federal expenses is not, therefore, so much of a sacrifice for them as for the others who need all their resources for working up to the national level.

Several methods have been adopted to find a basis of comparison between states regarding the incidence of taxation. The Irish Financial Relations Committee (1894–6) based their comparison on Ireland's total "annual wealth" to that of Great Britain. The Committee calculated the ratio to be one to 17. After making an arbitrary deduction for subsistence, they concluded that Ireland's taxable capacity could not exceed

one-twentieth of that of Great Britain. They found that Ireland was paying one-eleventh of the tax revenue of the United Kingdom, and, therefore, was burdened with two and three-quarter millions sterling in excess of its proper share. This basis of comparison of the annual wealth of two countries for purposes of taxation is imperfect. It ignores the idea of the taxability of individuals. The size of the *per capita* earnings in a country and the nature of the distribution of wealth and income among its inhabitants are as important considerations in gauging its economic strength as the total of its annual wealth.

Professor Giblin has worked out indices of "relative taxable capacity" in the several States in Australia on the basis of the federal income tax assessments, modified by certain other figures, like the federal land tax and estate duties.[1] Professor Findlay Shirras has compiled index numbers for India on the basis of "population, production, consumption of necessaries, number of letters, and post-cards delivered, revenue and expenditure, agricultural and non-agricultural income, tax collections including personal incomes assessed to income tax and super tax."[2] It must, however, be remembered that these indices are based on the monetary value of wealth, which

[1] Economic Record, November, 1929.

[2] Economic Journal, 1930.

may not be the same as the real value of wealth in the different states under comparison. The level of prices may differ in different states. Hence a comparison of figures based on money may not be a comparison of real wealth. Moreover, the exact economic strength of the states may not be revealed by these figures in cases where the burden of internal taxation and the size of beneficial services rendered, differ from one state to another.

The federal tax scheme should be considered in conjunction with the effects of federal expenditure. The inequality of treatment in federal taxation may be corrected by the policy pursued by the federal government in distributing the benefits of its services. Financial adjustments by assignments to and contributions from states also modify the burden laid by taxation. In Queensland, for example, the effects of the federal tariff were offset by a bounty on the sugar industry. The financial system has thus to be regarded as a whole, if a comparison has to be made of the net burden of federal costs borne by the individual states forming the federation.

In dealing with problems of the incidence of taxation and the economic strength of the states, another important factor to be considered is private and commercial finance. Governmental finance is only one of the forces acting on the economic welfare of a community. The activities

of commercial finance have far reaching results and may modify or aggravate the effects produced by the financial operations of the government of the country. When comparing inequalities of the incidence of taxation, the interest of the union as a whole, and the objects for which it is formed, should be kept in view. Any attempt to establish an exact uniformity in the incidence of the federal tax scheme is not only impracticable but would also cut out the possibility of taxing the several states "progressively." A tax which does not discriminate formally between the states but has an unequal incidence, may be justified from the point of view of the welfare of the federation as a whole, if it corrects gross inequality among the states or gives a fillip to the backward states to improve and join the onward economic march of the nation.

Double Taxation

In modern industrial life, the activities of a person or corporation are not generally limited within the jurisdiction of one particular authority. A person may live in one state, own property in a second, and carry on business in a third. He may derive his income from property or business in one and spend it in another state. He may die in one state and leave his property within the jurisdiction of one or more other states. A

corporation, similarly, may be formed in one, have its offices in another, and carry on business in yet another state.

If every state in the federation taxes persons and corporations on the same principle, there may be no case of double taxation. The same person or object is taxed twice or several times when one state levies taxes on the basis of domicile, while another taxes all income derived within its boundaries whether by resident or non-resident persons. Thus it is necessary to determine the proper jurisdiction entitled to levy the tax, or the proper shares of competing jurisdictions in the subject of a tax for matters of assessment.

Among the different tests of fiscal obligations to a state, is the old principle of political allegiance or citizenship. The citizen was taxed while the stranger was exempt from duties. But in modern times when the migration of persons and capital is so wide and frequent, a state cannot confine itself to taxing only the citizens and their capital, while the number of foreigners doing business, and the amount of foreign capital employed within its territories may be very considerable.

Another principle employed is that of residence. Temporary residence cannot serve as an adequate basis for taxation. It is clearly unreasonable to tax a traveller when the relations between him and the government within the jurisdiction of

which he happens to be at the time may be very slight and immaterial. Permanent residence or domicile is a stronger reason for taxation though it cannot be used as an exclusive test for assessment of taxes. Many of the persons who own property within the state may be domiciled in other states. The state will lose its revenue in respect of these persons. It may, however, gain at the expense of other states with regard to those persons who live within its territories but derive their income from property or business in other states. Moreover, if the principle of domicile were to be employed exclusively, persons who live in one place and own large businesses in another will not contribute towards the welfare of the place whence their profits are derived.

Location of property may serve as another test of obligations. But for similar reasons it cannot be an exclusive test. Permanent residents who are well-to-do owe some duty to the place where they live, even if their property is situated elsewhere.

In such cases, therefore, where the economic interest of a man is spread over several jurisdictions, equity demands that the whole of his "faculty" should be taxed, but taxed only once, the several jurisdictions sharing the tax in proportion to his economic interest under each. The idea of "faculty"[1] in taxation involves two

[1] Seligman: "Progressive Taxation in Theory and Practice."

considerations—one connected with production, the other connected with consumption. A man's faculty assessable for a tax would be composed of his activities of acquisition and earning, and those of spending and enjoyment.

A division on this basis could be made if the state from which earnings are received appropriates the taxes on production, that is, on property, income or business and the state where the person concerned lives and spends his income levies taxes on consumption. This plan, however, is beset with difficulties, because expenditure is not generally accepted as a satisfactory basis of revenue. Where taxes on consumption are not resorted to, it is necessary to make a division of the taxes on production. Such a division is bound to be arbitrary, but it is better than no division at all, because in the absence of taxes on consumption, the state where the income is spent will lose its legitimate share of revenue.

In the United States, Germany and Switzerland, the rule of *situs* is applied to real estate. This is taxed where it is situated. With regard to business or personality some countries observe the rule of *situs* while others that of domicile. In the United States the principle that personality follows the owner—*mobilia personam sequuntur*—is followed in many States. Hence if the owner is a non-resident, his personal property may be taxed

twice, once by the State where it is situated and again by the State of his domicile. Several States have, nevertheless, by statute or by judicial interpretation, provided for the exemption of a resident's personality, if permanently located and taxed in another State.

Such exemption is available in Alabama, California, Connecticut, Indiana, Louisiana, Maine, Missouri, New Jersey, Ohio, South Carolina, Vermont, West Virginia, Illinois, Kansas, New York and North Carolina.

In Germany a citizen is subject to direct taxes only in the State of his domicile or where he has no domicile in the State of his residence. Real estate and fixed industry (stehende Gewerbe) is taxed only in the State where the real estate or place of business is situated. If there are several such places the tax is divided among the States concerned according to a fixed proportion. The conflicts in interlocal taxation have been left for adjustment by interstate agreements, and not a few of these have been concluded among the several States. In Switzerland the law of 1885[1] laid down rules to avoid double taxation. · Inheritance taxes are assigned, in the case of real estate, to the Canton where it is situated and in the case of personality to the Canton where the deceased was domiciled. Other taxes

[1] See B. Van Muyden: "Exposé critique de la jurisprudence fédérale en matière de double imposition."

are divided according to the principles governing the regulations in Germany.

In India, owing to the absence of any regulations of mutual agreements between the States and the British Indian authorities, double taxation occurs not only in the case of incomes but also in the case of commodities. Articles imported from abroad are taxed at British Indian ports and again at the frontiers of those States which levy their own customs duties. It is only in the case of Kashmir State that a refund of the duty levied at the ports is made in respect of goods consigned in bond to the state. As regards incomes, a subject of a State residing in a Province is liable to the British Indian income tax on his income received from the State as well as on his income earned in the Province. The income he receives from the State is thus liable to double taxation.

According to the doctrine of economic interest instead of taxing the same object twice there should be a division of the tax between the jurisdiction where earnings accrue and the jurisdiction within which they are spent. This is the case in inter-statal relations in the United States, Germany and Switzerland. In international relations, however, a resident alien is not exempt from taxation on his property abroad or his income earned abroad.

A resident citizen is generally taxed on his property abroad or his income from abroad in international relations according to the principle of political allegiance. But in local and state taxation the principle of *situs* is followed in most countries. A non-resident citizen, however, is exempt generally from taxes on his foreign property and income not only in local and inter-state regulations but also in inter-national relations.

A non-resident citizen should be taxed on his property within the state and his income earned at home. A division, however, should be made of these taxes allowing the state of his domicile to raise a revenue from the use of his earnings from property or business. In Massachusetts and Virginia, income tax applies only to residents, thus leaving the income of the non-resident citizen to be taxed by the State where he lives.

A resident alien is invariably taxed on his property and on his income earned in the state of his residence. In his case the principles of *situs* and domicile are found together. A resident alien is sometimes taxed at a higher rate than a citizen, or is taxed where the citizen is exempt. In the United States, in some cases, foreign corporations are taxed more heavily than domestic corporations. In most cases there exist reciprocal laws between States by which one State taxes resident aliens in

the same way as its citizens resident in the other State are taxed.

As regards a non-resident alien having property or deriving income within a state, the principle of *situs* is observed in international relations and the property and income are invariably taxed. In the British Empire, inheritance taxes are levied simultaneously by the mother country and by the governments of the Colonies or the Dominions. At one of the Imperial Conferences, New Zealand made a strong but unsuccessful representation against this kind of double taxation.

In state and local taxation, tangible property is taxed where it is located. But in the case of intangible property, which cannot have a definite *situs*, the problem arises as to whether it should be assigned the domicile of the owner and thus regarded beyond the jurisdiction of the taxing power or whether it may be considered to have an economic *situs* in connection with the tangible property on which it is based.

In the United States on the recommendation of the Committee of National Tax Association (1911), several States impose a tax, in the case of residents, upon all their intangible property and upon such tangible property as was within the state, but in the case of non-residents only the "tangible" property within the State is taxed. Certain other States like Maine and Vermont

allow a resident descendant's estate credit to the extent of the taxes imposed on the same inheritance by another State.

The problem of avoiding double taxation by competing authorities thus exhibits many practical difficulties. It gives rise to questions as to what constitutes the taxable faculty of a person, and what should be the proportion in which two or more states, over which the economic interest of a person extends, should divide the taxes. The solution seems to be the adoption by all states by mutual agreements of the rule that a large part of the tax should be received by the state where the property lies or whence the income is derived, and the smaller portion should go to the state of the domicile of the owner. In the absence of a general acceptance of this rule a division of taxes between the states of domicile and *situs* may be made on the basis of tangible and intangible personality, but it would be far from being a satisfactory plan. Intangible property may include corporate securities, while the corporation may be already taxed in the state where it is situated. It may again consist of a mortgage on real estate abroad which is considered realty in the other state and is already taxed. An alternative plan suggested by Professor Seligman is that only realty and tangible personality should be taxed and the revenue should go to the state where it is situated.

Intangible personality may be reached by some form of federal taxation and the proceeds apportioned among the several states.

A division on the basis of tangible and intangible personality is thus imperfect. It can be avoided by taxing the whole faculty of the person concerned wherever it may be found, and by dividing the total proceeds of these taxes in fixed proportions between the states concerned. According to the principle of economic interest the state having the *situs* or the place from where earnings come should receive a larger portion of the proceeds than the state of *domicile* or the place where they are spent. An all-round agreement on this basis among the states concerned will obviate double taxation.

CHAPTER VII

FINANCIAL ADJUSTMENTS

A DIVISION of tax resources, however, judiciously carried out, cannot guarantee to the respective authorities revenues exactly sufficient for their needs. The yield from a particular tax may vary from time to time. Owing to the shrinkage of the proceeds of taxes, one state may suffer a deficit harmful to its economic welfare, while another may enjoy a surplus not altogether necessary for immediate use by an increased yield from its taxes. Thus, what the German writers call an "Independent System" (Trensystem), wherein the various authorities derive their revenues from independent sources without concurrency or contact, will not evidently make for the most useful employment of the revenues of the country as a whole.

On the other hand, if one government, for lack of assistance from others, squeezes too hard the object or objects of revenue at its disposal, the yield will not be proportionate to the rise in the scales of the tax and the national economy may suffer from undersirable effects. If the federal

government has to rely solely or mainly on customs duties, and if it finds the means for its growing demands by increases in the scales of the duties, the whole country will be subjected to a high-pitched protectionism.

Separation of financial resources is the basic principle of federal finance. Fiscal independence and responsibility is the natural corrollary of governmental autonomy in a federation. But in the interest of the welfare of the nation as a whole, it is necessary that the several units and the central government should maintain a system of financial adjustment among themselves to balance and supplement the antonomy of their finances.

German writers have contrasted the "Independent System" with a "Mixed System" (Michsystem), which may be of two kinds, the "concurrent mixed system" and the "contact mixed system." Under the former certain sources are taxed by the federal and the state authorities concurrently and no funds are transferred from one to the other. Under the latter, the federal and the state governments keep up financial contact through transfers from one to the other or vice versa.

The various possible ways of assigning concurrent powers and of sharing a tax have been discussed in Chapter III. The plan of sharing proceeds or assigning a percentage or a fixed sum from a tax, is best suited to cases where in the interest of

economy, simplicity and efficiency, the subject should be administered by the central authority. The tax shared should also be able to yield enough to feed both the federal and the state governments.

Under such a plan of assignments, the problem arises as to the basis on which the distribution of proceeds should be made. The figures of actual tax collections in the several states may not serve as a satisfactory guide for distribution of proceeds. The doctrine of " economic interest " would suggest a division among the several states on the basis of origin or residence. The revenue of the tax in question would presumably go to the states, if the central authority did not collect it for reasons of efficiency. The states would thus require to be compensated by a distribution of the proceeds on the basis of " economic interest." But from the point of view of a national economy, it may be desirable to deviate from the principle of compensation and distribute the proceeds among the several states on the basis of population or economic requirements, so that the poorer states may profit by what richer states may reasonably spare. Hence it is not necessary to aim at anything more than rough justice when deciding on the basis of the distribution of a tax.

Another method by which the federal and the state authorities derive common revenue from a single tax source, is that of supplementary levies.

The states collecting federal taxes may levy a surcharge for their own purposes, or the federal authority collecting a tax on behalf of the states may impose an additional percentage for its own requirements. In France under the pre-war financial system, the revenue of the central government was derived from four principal taxes—the land and building tax, the business tax, the personal property tax, and the door and window tax. The *départements* (provinces) and the communes obtained their revenues by supplementing these with percentages of their own as *centimes additionels*. After 1917, when the central government replaced the four taxes by others which were not suited for the purpose of supplemental levies, the *départements* and the communes levied their *centimes* by assuming a " principal fictatif."

Under the new constitution in India the income tax is not only to be shared on the basis of a fixed percentage between the Federal and the Provincial governments, but is to yield a supplemental revenue to the Federal government when it imposes a sur-charge on it for its own purposes. The Federal government has authority to levy a similar sur-charge on certain succession duties, stamp duties, terminal taxes and taxes on fares and freights.[1]

The sur-charge for Federal purposes levied on

[1] Articles 137 and 138 Government of India Act, 1935.

income tax is to be paid in a lump sum by those States also, who do not enter the income tax Scheme in the Federation. In their case the surcharge will be determined on a calculated basis of what the aggregate amount of their income tax would be, if they entered the income tax scheme.

The plan of supplemental levies works satisfactorily under certain conditions. It is necessary that the tax concerned should be productive enough for the purposes of the federal as well as the state governments. After a certain limit an increase in the scales of the tax may lead to progressive diminution of the revenue of all the governments concerned. The economic harm which may be caused by such a contingency, may be avoided by mutual agreements regarding the maximum limit to which the supplementary rates can be raised. The other condition necessary for the proper working of this system is that the tax chosen as the "principal" should be levied in all the states on a similar basis, whether of *situs* or origin. Otherwise it would lead to an illegitimate distribution of the incidence of the supplemental levy, when double taxation occurs in the case of the "principal." It has been seen that in the case of a citizen of a State in India who resides in a Province, his income is liable to be doubly taxed owing to the British Income Tax Law in the Provinces which operates both on origin and

situs. The Federal sur-charge in this case will have an unreasonable incidence both on the State and the Province concerned.

State Contributions

The more important factors in the system of financial adjustment in a federation are payments from the states to the federal government and *vice versa* outside the tax scheme. The federal government may not be made entirely dependent on the contributions of the states. The experience in the United States in the confederal period and in Imperial Germany, indicates the defects of a system where the central authority does not enjoy independence in its resources. In India, the Provinces were obliged to pay contributions to the central government under the Meston Award.[1] But the system did not work satisfactorily as the scales of contribution caused a lot of jealousy and heart burning among the Provinces.

The contributions made by the Indian States to the central government deserve study, as they have a different character and all attempts to arrive at their true value in a scheme of financial adjustment have been complicated by political considerations.

The contributions made by the States to the central government in India, beside their share of

[1] See Chapter III.

the taxes, may be divided into three classes—defence services, cash subsidies and ceded territories. Under their treaties in general, the responsibility of defence rests with the Imperial government. But the States, of their own accord or on invitation, have rendered the British Government considerable assistance in this regard. The Indian State Forces, maintained on practically the same lines as the British Indian Army and in part advised and assisted by British officers, are an integral part of the general scheme for the defence of India.

During the War, the Indian States placed all their military resources at the disposal of the British Government. Their regiments fought in all the fronts. Some of the Rulers themselves saw active service, rendered moral support and created enthusiasm in India for the wholehearted backing of the War.[1] Two of them[2] served as members of the Supreme War Council. The strength of the Indian State Forces is 49,370. The total strength of the British Indian Army in 1933 was 254,350, at a cost of 49.5 crores of rupees. The Indian State Forces are not maintained on the same

[1] A "firman" issued by H.E.H. the Nizam of Hyderabad, the ruler of the largest State and a Muslim, dispelled doubts from the minds of the Muslims in India about the propriety of fighting against Turkey and in Arabia and Iraq.

[2] T.H. the Maharajas of Patiala and Bikanere.

expensive scale as the Indian Army, but it would cost roughly 9.6 crores a year for the central government to maintain 49,370 troops.

The States have a just claim in regarding these services as contributions and requiring that they should be counted upon in the scheme of financial adjustments. The Indian States Enquiry Committee (1932) admitted "that the existence, strength, and efficiency of these forces cannot be ignored," but decided not "to attempt to translate into a money equivalent the value to be attached to the military contributions of the Indian States."

The cash subsidies paid by some States to the British Government amount to Rs. 75 lakhs annually. These, however, have been found by the Indian States Enquiry Committee to be incompatible with the Federal financial system and therefore will be remitted gradually within twenty years from the date on which they enter the Federation.

There are five states, Hyderabad, Baroda, Gwalior, Indore and Sangli, which have ceded territories to the British Government in India so that it may maintain out of their revenues a specified number of troops for the service of the States concerned. These territories, excluding Berar,[1] have been calculated to cover an area of about

[1] Berar was not "ceded" but given over on a "permanent" lease and so is still under the sovereignty of H.E.H. the Nizam of Hyderabad.

40,000 square miles with a population of nearly ten million.

At the time when the territories were surrendered an estimate of their values was recorded. The number of troops and the amounts for which the different States assigned these territories are as follows :

State.	Troops for the maintenance of which the territories were ceded.	Cost of the subsidiary force at the time of Treaty.
Hyderabad .	8,000 infantry and 1,000 cavalry with guns.	Rs. 24,17,100
Baroda . .	4,000 infantry, two regiments of cavalry, one company of artillery, and two companies of gun luskars, with necessary ordnance, warlike stores and ammunitions.	24,43,007
Gwalior . .	6,000 infantry with artillery and stores.	18,00,000
Indore . .	3,000 horses	1,11,214
Sangli . .	For exemption from military assistance of a feudal character.	1,35,000

The Indian States Enquiry Committee valued the contribution of these States excluding Hyderabad, towards the cost of defence to the Central Government at Rs. 36.96 lakhs, which is approximately the cost of maintaining the specified number

of troops at the time when the treaties were made. On the side of the States, however, the cash value of these obligations is calculated according to the standard of the present cost of the Indian Army, and estimated at 487 lakhs (including 175.32 lakhs for Hyderabad). The more liberal estimate is supported by the fact that the revenues of the ceded or leased territories have multiplied since the time of the treaties. The States have felt that their contribution in this regard has been undervalued, and proposed that if the territories were given back to them, they would maintain or pay for the cost of the specified number of troops according to modern standards, or would bear their rightful burden in any defence scheme of the Federation.[1]

The question could not, for political reasons, be approached from this point of view. As an alternative it may be assumed that a retrocession of the territories has taken place, and deducting the cost of administration and the cost of the specified number of troops according to modern standards,

[1] H.E.H. the Nizam of Hyderabad has claimed that the "permanent lease" of Berar should be terminated. Among other reasons affecting the validity of the original contract itself, it was argued that after deduction of the modern cost of the specified number of troops and the cost of administration of Berar, the net revenues of the sub-province have been vast and bear no proportion to the amount of Rs. 25 lakhs paid annually on this account to Hyderabad.

the revenue surplus may be counted towards the contribution of the States concerned. The Indian States Enquiry Committee has only accepted in principle that these States cannot be asked to contribute to the Federal government on the same basis as other units of the Federation. They have made the proposal which the States concerned can hardly accept as sound and simple finance that the net revenues of the territories at the date of cession should be set off against the contribution for defence which these States would be called upon to pay on entering the Federation. The details will be agreed upon when the Instruments of Accession are drawn up by these States.[1]

Federal Subsidies and Subventions

Federal subsidies are payments made unconditionally by the federal government to the states. These are generally based on provisions in the constitutions and are paid as compensation for loss of revenue by the states incurred on the transfer of certain resources like customs or excise to the federal government.

In Switzerland, the Federal government granted compensations to the Cantons in respect of their loss of revenues when it assumed the control of customs and also when it established a postal

[1] In this connection see Article 147, Government of India Act, 1935.

monopoly. These "legal" payments in compensation were, however, abolished from 1890 except in the case of the cantons of Uri, Grisons, Ficino and Valais. In 1887, when a Federal monopoly of alcohol was established by referendum, it was laid down that the whole of the profits was to be paid to the Cantons subject to the condition that they spend 10 per cent. of these payments to combat alcoholism. In 1905 the Swiss National Bank was established and the right of the Cantons to issue notes or to tax banknotes was abolished. As compensation a certain portion of the profits of the National Bank has to be paid to the several Cantons.

In Canada, the subsidies granted to the Provinces as compensation for loss of revenue in respect of their right of customs and excise were of two kinds: (*a*) a specific annual subsidy to meet the expenses of the governments concerned, and (*b*) an annual subsidy on a *per capita* basis. The specific annual subsidies granted were as follows:

Ontario	$80,000
Quebec	$70,000
Nova Scotia . . .	$60,000
New Brunswick . .	$50,000
Manitoba . . .	$30,000
British Columbia . .	$35,000
Prince Edward Island .	$30,000
Alberta	$50,000
Saskatchewan . . .	$50,000

The *per capita* subsidy was fixed at 80 cents. per head of the population as recorded by the census of 1861. The basis of the subsidy was to be adjusted for each subsequent decennial census for Nova Scotia, New Brunswick, Manitoba, British Columbia and Prince Edward Island, until the population reached a maximum of 400,000 each. New Brunswick was granted an additional subsidy of $63,000 annually for a period of ten years, for its reconciliation to the federation.

The Provinces, however, have not been satisfied with the subsidies they have received. In the Inter-Provincial Conferences of 1887 and 1902 it was pointed out that the proportion of subsidies to the total revenue of the Dominion had dwindled down from 20 per cent. in 1867 to 13 per cent., while the Dominions revenue from customs and excise had enormously increased. In 1907 an Act of the Imperial Parliament provided for (*a*) a fixed annual subsidy to each Province for its general government on the basis of a certain minimum and maximum of population, and (*b*) a *per capita* subsidy at the rate of 80 cents. per head of the population on the excess only.

Similar to the problem of subsidies and the insatiable demand for them by the Provinces is the problem of crown lands and natural resources in Canada. The Dominion Government has been paying subsidies as indemnity to the Provinces

for their rights over these lands, or as compensation to those Provinces which did not have the public lands owned by others. The claims of Saskatchewan and Alberta in this regard have been examined recently and the commissions appointed for the purpose have recommended (March, 1935) a sum of five million dollars for each to compensate for the control retained for 25 years by the Dominion Government over their lands. The White Commission of 1934 examined into the question of subsidies to the three maritime Provinces and has awarded annual subsidies aggregating to $2,475,000.[1]

The system of subsidies has been found by experience to be a very unsatisfactory means of financial adjustment. The states begin to feel an inalienable right to any surplus accruing to the federal government. This was the impression in Australia disclosed in the Ministerial Conferences before the Commonwealth Government decided to abolish the subsidies. Even in Canada, where subsidies have been the leading feature of financial adjustments, the Dominion Government has now resorted to the system of conditional payments with supervision over their expenditure in the Provinces. Through this better method of federal aid the Dominion Government now assists the

[1] "Federal-Provincial Financial Relations." D. C. MacGregor in Economic Journal, March, 1936.

Provinces in agriculture, trunk roads and highways, certain branches of hygiene, unemployment and old age pensions.

Federal subventions or conditional payments are a more regular feature of financial adjustments. They are paid to the states for specific purposes and subject to the condition that the function concerned is performed efficiently under a general supervision of the federal government. They are subject to the annual vote of the federal legislature.

In the United States the first instance of a subvention to a State was in 1802 when 700,000 acres of land were given to Ohio. The Morrill Act of 1862 introduced federal aid for technical education and mechanic arts, by the grant of 30,000 acres of land for each senator and representative from the States. In 1887 and in 1890 annual money votes were instituted for the promotion of agricultural research and advanced training.

During recent times the size and importance of federal subventions has continually increased. The Federal Aid Road Act (1916) affords financial assistance to the states in co-ordinating the highways on a national standard. Nearly 30 million dollars are paid to the States annually towards the cost of the National Guard. Over 19 million dollars are granted under the Smith-Lever Act, the Vocational Education Act and the Industrial Rehabilitation Act for education, agricultural train-

ing and civilian rehabilitation in the States. Federal aid is also granted for the preservation and extension of forests and certain branches of hygenic services.

The Federal subventions in the United States are granted subject to the condition that State expenditure is supervised by the Federal government. In the case of inefficiency in the administration of the grant, they may be withdrawn. The State governments are also required to match the Federal subvention dollar for dollar. The subventions are apportioned among the several States, mainly on the basis of population. In the case of agricultural services, the rural population is taken into account; for vocational education, a combination of rural and urban population is made, and in the case of highway works the total population and the mileage of the roads compute the basis for apportionment. In most cases the Federal government prescribes certain national standards, e.g. in education and highway construction to which the states must conform.

In Switzerland, the Federal government pays nearly 60 million francs to the several Cantons for the promotion of agriculture, canal works, education, forests, fisheries and police control. Certain functions of a national importance, like health insurance and unemployment benefit, are performed by the Cantons in conjunction with the

Federal government. They receive annual subventions for these services.

The main feature of financial adjustment in Switzerland has thus been the system of subventions. Although the Cantons have shared certain percentages in the Federal war taxes and the customs duty on petrol, their principal receipts from the Federal government have been in the shape of conditional payments. The Federal government has favoured this system in order to pursuade the Cantons to agree to a widening of its taxing powers.

In Australia, under section 96 of the constitution, grants have been made by the Commonwealth to Western Australia since federation, to Tasmania since 1912–13, and to South Australia since 1929–30. From 1923 the Commonwealth made a grant of £500,000 to the States for construction of main roads. In 1926 the Federal Aid Roads Act instituted a grant of £2,000,000 for a period of ten years, for the construction and maintenance of inter-state roads. The States supplement the grant at the rate of 15s. to each £. given by the Commonwealth Government. Educational institutions in the States are also awarded grants-in-aid. The administration of these funds is subject to a general supervision by the Commonwealth Government and the subventions may be altered or withdrawn in case of inefficiency. The table on page 117

analyses the total Commonwealth contributions to the revenue of the States from federation to June, 1935.

The subventions of the federal government have to be distributed among the several states, according to some principle. One of the reasons put forward for federal aid is that certain states are disadvantaged by federal policy and that justice demands that these states should be compensated to the extent of the damage. As the Commonwealth Grants Commission of Australia puts it, "the ground for a grant should be the adverse influence of Commonwealth policy, and the simplest form of the issue would be the proof of a disability through Commonwealth policy, the assessment of the loss occasioned and a recommendation for the sum so ascertained to be given." This principle of compensation is useful to indicate the necessity of federal assistance. But in practice it has to be qualified by two considerations. It is, in the first instance, difficult to measure the effects of federal policy. The economic effects of the federal tariff, for example, are so mingled with other effects that it is difficult to separate them to be sure that a lower national income per head for one state, as compared with another, was entirely due to the tariff. Secondly, when considering the effects of federal policy, it is also necessary to bring into the calculations the benefits of federal

£A. MILLIONS.

	N.S.W.	Victoria	Q'ld.	South Australia	Western Australia	Tasmania	Total
1. Contributions under Section 87 of the Commonwealth Constitution (Braddon Clause) 1901/2–1909/10 .	26.8	18.8	8.3	5.9	8.3	2.4	70.6
2. Payment of 25/– per head of population, 1910/11–1926/7 . . .	41.5	31.2	15.2	9.9	6.9	4.4	108.9
3. Contribution towards Interest on States' Debts, 1927/8–1934/5 .	23.3	17.0	8.8	5.6	3.8	2.1	60.7
4. Contribution towards Sinking Fund Payments on States' Debts, 1927/8–1934/5	3.4	1.9	1.2	1.1	.9	.2	8.8
5. Road Grants, 1926/7–1934/5 . .	5.0	3.3	3.4	2.1	3.5	.9	18.1
6. Special "Disability" Grants and Payments	.8	.6	.3	6.3	6.8	4.2	18.9
7. Grants for special purposes 1930/1–1933/4	1.7	1.4	.2	1.3	1.1	.1	5.8
	102.6	74.1	37.4	32.1	31.3	14.4	291.8
8. Relief to other Primary Producers, 1932/3 and 1934/5 . . .							4.8
						Total	296.6

expenditure. In Australia, for example, the unequal burdens of the Commonwealth tariff have to be studied along with the unequal benefits conferred by the depreciation of the Australian pound.[1]

Professor Giblin has set forth the principle of need as the basis of the distribution of federal aid among the states: "A persistent deficiency in taxable income is in itself the most valid and convincing evidence of the need for federal assistance and between states is a fair measure of the relative need for it."[2] He has laid four conditions which, in his opinion, should be observed if assistance is to be granted to a state:

(1) It should be taxing its people with considerably greater severity than the federal average.
(2) It should not be attempting social provision on a more generous scale than the average.
(3) Its cost of administration should be below the average.
(4) It should for some years, at least, have shown consideration and caution in loan expenditure.

The four tests indicated establish satisfactorily the need of a state for federal subvention. If a

[1] For a discussion on the effects of the currency policy in Australia see R. C. Mills: "Commonwealth Grants to States," Economic Record, March, 1935.

[2] Report of Commonwealth Parliament Public Accounts Committee on Tasmanian disabilities No. 108 of 1930.

state drifts into an irretrievable position, it is in the interest of the federation, as a whole, to assist it. In considering the relative needs of different states on this basis it is, however, necessary to bear in mind that averages arrived at on the basis of population for these comparisons may not be altogether exact. If a state is sparsely populated, it is possible that its *per capita* expenditure on social services may considerably exceed that of others which are more thickly populated. A combination of the principles of compensation and need is found in the method advocated by Mr. Brigden for Australia.[1]

(1) Ascertain the true budgetary position of each state according to a common standard of accounting.

(2) Determine a standard accordingly. (The average of the non-claimant states may be used).

(3) The difference between this standard and each claimant state, less the special grant received, gives the *crude* amount required as a special grant for that year.

(4) Add any expenditure required to maintain capital equipment at the standard of other states.

(5) Add any amount estimated to represent the moral responsibility of the federal government for any particular state expenditure.

[1] Economic Record, December, 1934, p. 235.

(6) Deduct so much as represents expenditure due to any mistakes in policy (developmental or otherwise), in excess of a standard to be determined.

(7) Deduct so much as represents expenditures on administration or social services in excess of a standard to be determined, or add for subnormal expenditures.

(8) Deduct so much as represents taxation below a standard of severity to be determined, or add for excess severity.

Federal aid to the states has been objected to on the ground that the states lose their freedom of action in accepting the subventions and that through financial assistance the federal government enlarges its political power. It is beyond doubt that federal supervision over the subsidised activities of states brings about a certain measure of centralisation. But grants made without imposing an obligation regarding the purpose and the method of their expenditure are liable to be misused. Such subventions made by federal governments are as a general rule, for those objects and services in which a measure of central co-ordination is beneficial or in which state activities can with advantage, conform to a national standard. Besides, if a state disapproves of the measure of federal intrusion involved in a grant, it can always abstain from drawing it. As Dr. Finer puts it,

"It is only a sanction." The state is under no compulsion to accept it.

The scheme of financial adjustment (Finanzausgleich) should, however, be based on adequate independent resources to the states as well as the federal government. As far as possible the several governmental authorities in a federation should be able to enjoy confidence in their means of raising money. This promotes responsibility in expenditure, stability in budgetary systems and a longer vision in programmes for economic development.

A perfect balance between the needs and tax resources of the several governments is, however, impossible. Owing to the centralising tendencies in modern economic life, certain taxes are better administered by the federal government, though their proceeds are needed by the states. Hence, through their tax revenues the central government receives more and the states less than their requirements. As the Commonwealth Grants Commission in Australia remarked: "A government is not being responsible if the normal exercise of its powers gives it more money than it needs, especially if this result is accidental, as in the case of a customs tariff imposed for protective purposes. Nor can the principle of responsibility be satisfactorily applied, if governments receive less than they require for their essential needs. In the latter case services are starved, finances are embarrassed

and drift follows. In the former, governments become extravagant."

A distribution of this surplus is necessary and by a discriminate allocation it is possible, as President Coolidge said, " to apply the resources of the nation to those points where they are most needed and thus strengthen the weakest link in the chain." The system adopted for the financial adjustment should provide for a measure of automatism in its working and should be a supplement to an independent allocation of resources. It should " fill in the gaps " left over by such allocation.

CHAPTER VIII

NON-TAX REVENUE

States derive revenue from other sources than ordinary taxation. In all new countries, governments have raised money from public lands by the sale of their produce or proprietary rights. Land held and tilled in common is, however, rare except in Russia. In Germany the States derive large revenues from forest industries and sale of forest produce. Coastal and deep sea fisheries are generally controlled by the national governments, who raise a revenue through their rates and charges.

Governments have also entered the field of business and enterprise, among other reasons for purposes of revenue. Means of transport and communications, like railways, tramways, autocar services, canals, posts, telegraphs, telephones, broadcasting, airways, shipping and ship-building have been controlled by state agencies for purposes of revenue as well as for exercising public supervision over these utilities.

It may not be appropriate here to enter in great detail on a discussion of the propriety of business

by governments. The characteristics of "maturity and monopoly" are generally designated as "strictly economic earmarks for state managed industries." The economic characteristics which make certain industries more likely than others to be successful under public management may be noted below:

(1) The capital invested should be small in proportion to the year's business, as in the post office, or subject to easily calculated depreciation charges, as in water supply.

(2) Simplicity of operation.

(3) Certainty and immediacy of returns.

(4) The service or commodity should be universally or very widely used in the governmental jurisdiction.

(5) The industry should be mature and should not call for exceptional inventiveness.

Thus some types of industries are better fitted for government ownership and operation than others. But the success of state-managed industries depends as much on the kind of governmental administration as on the field of activity. Public management is apt to be political management and may not be sufficiently technical. A government managing a business is apt to disregard the gravity of a loss sustained, as it can, in the words of Thomas A. Edison "always shift its losses to the taxpayers."

The history of railway construction in India illustrates the importance of the non-economic considerations in such activities of the state. At the time when the great trunk railways were constructed in India it was expedient for the British Government to link up the different important " points of power." The speedy transport of troops was in the case of many lines a greater consideration than their value from the point of view of the economic development of the country. The government guaranteed the rate of interest on the capital spent by the railway companies in construction. Thus it was that capital was so lavishly sunk in laying these lines and weighs so heavily on their profit earning capacity.

In most federations, railways were built in pre-federation days and were the property of the different states. But there has been a tendency to vest their control in the federal government. In Switzerland the railways were originally private enterprises under the control of the Cantons. From 1872 the Federal government supervised them as private enterprises. In 1901 they were nationalised, and all lines are now Federal concerns. In Germany the Federal government had acquired control of the railways before 1920, when it handed it over to a private company under federal control. In South Africa, inter-statal rivalries in the operation of railways produced disastrous effects, before

they were federalised in 1908. In the United States and Australia the States own the railways, but the Federal government exercises supervision over rates and services either through legislation or through a special body like the Interstate Commerce Commission.

In India the management and control of government railways and the supervision of railways owned or worked by companies is vested in the Railway Board or the "Railway Authority" in the language of the Government of India Act. It is financially autonomous and contributes to the Central Budget a portion of its profits over and above a prescribed amount. Several States in India own and work railways within their territories. Through their Instruments of Accession they will accept a general supervision of the Federal Railway Authority over their railway systems. An appeal from the decisions of the Railway Authority may be taken by the State railways or the companies to the Railway Tribunal.

With regard to British Indian railway lines constructed through the territories of the States, the States concerned have a rightful grievance.[1] At the time of construction they gave the companies land and jurisdiction. They waived their rights to the transit duties on goods passing on these railway lines through their territories. But in

[1] See "Federal Finance in India," Professor K. T. Shah.

the management of these railways and the fixing of the scales and rates they have no voice. They feel again, that in the division of the final surplus of net profits from railways—after all the working expenses, interest dues, reserve and depreciation fund contributions have been paid—they ought to have a share in proportion to their population and the traffic they provide for these railways. In the alternative, they should be able to tax the railway companies on their earnings within their jurisdiction.

The profits derived by the central government from the postal department have similarly been the subject of discussion by the States. The States of Hyderabad, Patiala, Jhind, Nabha, Chamba and Gwalior have postal departments of their own. The treaties between British India and these States provide for a free exchance of correspondence between British or other States' post offices and the post offices of these States. But on lands primarily acquired for railway purposes in these States the central government has erected its own post offices which carry on good business to the immense prejudice of the States. For the States which have no postal services of their own the central postal and telegraph department renders the services of free postage for state correspondence. The department has its telegraph lines and offices in States. The States pay towards the maintenance of these

lines. They feel that their subjects bear the burden—so far as the post and telegraph rates include an element of burden—and that free service of state correspondence does not represent their proper share of the profits of the post and telegraph department.

It is, however, indisputable that these nation-wide utilities should be owned and managed by the central government. As the scheme of federation evolves, a complete centralisation of these activities will be necessary. But an essential basis of this centralisation is the provision for all united of the Federation to share equally the profits accruing from these commercial or quasi-commercial concerns. When the revenue derived from the Federal administration of the railways, post office and its extended activities of banking and insurance, salt and opium monopolies, irrigation projects and mint and currency [1] is shared by the States equally with the Provinces in the form of benefits of Federal expenditure, there will come a change in their attitude and they will not grudge the Federal control of these activities. All will willingly pay in the pool when all have a say in its distribution and profit by it.

[1] The States have complained that they have not had a fair deal in the matter of their irrigation schemes and riparian rights, and also claim a share in the mint and currency receipts of the central government.

The importance of public enterprise and state monopolies as sources of federal revenue has increased during recent years owing to the centralising forces in modern economic life. Business activities of various kinds carried on by states and local bodies are becoming more suitable for federal control as they assume an inter-state character. The responsibilities of central governments have been increasing in modern times. The federal government thus welcomes the revenue from these sources to meet its additional requirements, and finds it more convenient than tax revenue, which involves disputes regarding double taxation or encroachment in the field of state-taxation.

It is, however, necessary that the federal government should restrict its activities to matters of a national or inter-state character. It should not take up a business enterprise which is fixed and local in its nature, as, for example, agricultural and forest industries. Any public commercial organisation in these fields should naturally belong to the states.

The distinction between revenue from taxes and revenue from other sources becomes insignificant in a country where the whole economic life of the community is controlled and directed by its government. In the U.S.S.R. nearly 80 per cent. of the revenue comes from the "nationalised social economy" and nearly 75 per cent. of the expend-

ture is devoted to it. The Prombank and the Gosbank finance the industries on the long term and the short term basis respectively, as outlined by the plan. Prices of the consumers' goods and the producers' goods are fixed by the state authorities. The turnover tax levied for the state varies from 2 to 50 per cent. according to the nature of the industry. In 1932 a sum of 15,000 million roubles or 55 per cent. of the gross revenue was obtained from this tax.

A summary of the budget of the U.S.S.R. for 1932 is given on the opposite page.

It is evident that where the state manages the industrial and commercial activities of the people, the distinction between public and commercial finance or between tax revenue and non-tax revenue of the state is not of any great importance.

(In millions of Roubles.)

(1) From Socialised Economy:		
(*a*) Profits including rlys.		
(*b*) Turnover tax . .	21,874	
(*c*) Various . . .		
(2) From individuals:		
(*a*) Agricultural tax .		
(*b*) Cultural and housing funds . . .	4,890	
(*c*) Loans . . .		
(3) Other revenue . .	778	
	27,542	

(1) Financing National Economy:		
(*a*) Industry and electrification . .		
(*b*) Agriculture . .	20,079	
(*c*) Trade, supply, etc. .		
(*d*) Railways . . .		
(2) Education and other cultural services . .	1,557	
(3) Army and Navy . .	1,278	
(4) Administration . .		
(5) Exp. on state loans .	585	
(6) Local budgets . .		
(7) Others		
	23,499	

PART III
Problems of Expenditure

CHAPTER IX

FEDERAL EXPENDITURE

THE problems connected with the expenditure of a state are as important as those connected with its revenue. The state collects the revenue for spending it and it is to a large extent owing to the interest in its expenditure that problems of the size and the allocation of revenue are studied in such detail. The size and the modes of state expenditure have as much effect on the national economy as its tax collecting activities.

A reference has already been made to the widening and the increasing complexity of federal activities. Many duties connected with the economic development of the country now claim as much importance as the old function of common defence. The division of the fields of expenditure between the federal and the state governments has been on the basis of the functions.[1] Expenditure on the defence services in war and peace and the diplomatic and consular services is entrusted to the federal government to fulfil its obligations in connection with common defence and foreign relations. Subjects of inter-state importance are

[1] *Vide* Chapter III.

entrusted to the federal authority, which controls the policy regarding their expenditure. Hence the post office, telegraphs and railways are financed and controlled by the federal government. Expenditure in connection with the public debt is also federal. The United States Constitution gives Congress power "to levy and collect taxes and imposts to pay for the debt and provide for the common defence and welfare of the Union."

It has been previously noted that in certain cases one authority may find it convenient to employ the agency of the other to administer a certain subject and control its expenditure. These are generally state matters like agriculture, education or hygiene for which the federal government assigns certain amounts to the state authorities for expenditure in order to supplement their activities and to enable them to conform to national standards prescribed by it. There are not many cases in which the states supplement by their expenditure the functions which belong to the federal government. The case of the States in India, who spend large amounts to maintain armies to supplement the obligation of the Central Government for defence may, however, be noted.

The federal governments have in modern times enlarged their fields of expenditure, as a result of the centralising tendencies in government. The rise in the powers of the central government is

particularly noticeable in Germany, where it coincides with a centralisation of the financial administrative machinery. As the size of federal expenditure increases, its distributional aspect becomes more important. The benefits of federal expenditure are not distributed equally over the several states. In Australia, for example, the rivalry between the rural States and the manufacturing States is aggravated not only by the Federal tax scheme but also by the effects of Federal expenditure, on railways and by Federal subventions.

The effects of federal policy on the economic condition of the states may, however, be complicated with conditions peculiar to the several states, and a general rule may not be laid down in this regard. As a result of the Australian tariff, there has been a "boom" in the industrialised states. Property and assets have appreciated in value, on account of the large returns they bring in under the protective tariff. But there has also been a movement of population to these States. Hence against the benefit that these States derive from Commonwealth policy must be set off the increase in their administrative and social expenditure owing to the increase in their population. The sparsely populated agricultural States may, however, complain that a decrease in their population does not reduce the cost of their administration

proportionately. A certain size and standard of administrative machinery has to be maintained in a state irrespective of the low density of its population. The cost of certain services are relatively high in rural districts of low density. School buildings, for example, cannot be used to capacity. But they must be maintained. Mail services, again, may not be very busy, but the necessary staff has to be kept in employ.

The question of the uniformity of benefit from federal expenditure is similar to the problem of uniformity in the incidence of taxation.[1] The general policy of the federal government in its expenditure should be free from discrimination. The rule of "geographical uniformity" as enunciated in Knowlton *v.* Moore should be the guiding principle in expenditure as well as taxation.

However, in the interest of the welfare of the nation as a whole, federal expenditure may as a matter of policy be directed to benefit certain regions in special cases. The determination of policy depends on the attitude of the legislators and the will of the nation expressed through them. Any act prescribing such policy should also lay down among other conditions the object, the period and the extent of the expenditure.[2]

[1] See Chapter VI.

[2] As a similar rule may be noted one of the "Canons of Financial Propriety" in the audit of government accounts

In dealing with questions of uniformity of incidence and benefits it is necessary to study the effects of taxation and expenditure together. Where federal taxation imposes an excessive burden federal services may bring an extra benefit. If any comparisons are necessary to be made, they should be made on the basis of the net results of federal taxation and federal expenditure. The two sides are integral in significance and conclusions based on one of them alone may be far from being correct.

During the past few years, states are resorting to planning their economic activity. In a federal state, the constitutional status of the national, state and local governments keeps them apart as three non-communicating compartments. This is notably the case as between national and the state governments and leads to inefficient spending, inequitable taxes and burdensome debts. Public moneys are spent needlessly on duplicate and useless functions. Taxes are improperly distributed on the three levels, the financial burden being much heavier at some points than at others.

The need for co-ordination in expenditure policies is greater in times of crises. The financial policy

which lays down that "public expenditure should not be directed towards the benefit of a particular class or community, except under any policy laid down by government": The Audit Code of the Government of India.

pursued by the Federal authorities in the United States recently to combat depression has at least temporarily obliged the States to co-operate with Washington in certain phases of their financial planning. Several states in their turn now exercise supervision over local budgeting within their jurisdictions. Although constitutional lawyers may not agree, it is quite possible to devise a system of co-operative planning in financial matters in a federal state. In working out the details of such a system the existing governmental functions on the different levels should be examined with the idea of determining which function should be performed on each level and which should be carried on co-operatively. The financing of these functions, as redistributed, should then be studied in order to ascertain how their costs should be borne by the different levels.

CHAPTER X

THE ADMINISTRATIVE, BUDGETARY AND FISCAL SYSTEM

THE problem of administrative efficiency assumes greater importance in a federation than in a unitary state on account of the duality in its organisation. It is due to the existence of several governmental authorities that a federation is more exposed to the evils of tax-evasion, fraud, over-staffing and duplication of administrative machinery, double taxation, conflicts of jurisdiction and the improper incidence of tax burdens. Thus the finances of a federation need special administrative efficiency in their collection, custody and expenditure.

The problems dealing with double taxation and with the other aspect of the incidence of taxes have been discussed earlier. Besides the problem of the uniformity of incidence, there arises the question of uniformity in the methods of assessment, tax formulæ, dates of payment and modes of collection and refunds. A standardisation of financial practice is necessary not only from the point of view of economy, but also, as the Australian Royal Commission on Taxation remarked, to respect " the sovereign right of the taxpayer to

have the mechanism of taxation so designed and controlled as to impose the minimum of inconvenience and involve the minimum of cost." This applies not only to the official routine and technique on the expenditure side as well as on the revenue side. A certain measure of diversity and complexity in tax forms and expenditure forms, however, is unavoidable when certain revenue and expenditure heads have to be treated differently for budgetary and accounting purposes.[1]

In the interest of economy again, it is necessary to avoid the duplication of administrative machinery when two governmental authorities perform similar revenue or expenditure functions. As far as possible, the authority best suited to perform the functions efficiently and economically should be entrusted with them. In this connection a reference has already been made to the rival claims made by the Commonwealth Treasurer in Australia and the Treasurer of Victoria to collect the revenues of the other governments at considerably lower costs.[2] The nature of the functions concerned, that is, their "basis" whether narrow or wide and inter-state, should be the guiding

[1] *Vide*, for example, the rules and forms incorporated by the writer in "The Hyderabad Financial Code," regarding the different kinds of revenue payable in the State Treasury, and the different kinds of bills drawn from it for expenditure.

[2] Proceedings of the Ministerial Conference in Australia, 1919.

principle in their allocation to the state or federal authorities. For similar reasons one authority may, to a certain extent, or for a certain time, employ the agency of the other to perform its duties.

In a federation, the economic life of the nation depends on the economic behaviour of the several units. One or a few states acting irresponsibly may strain the whole federal structure. It is necessary, therefore, that there should be a measure of fiscal co-ordination among the states. In Germany the Ministry of Finance in the Federal government is kept informed of the fiscal legislation of the States including the budget, supplementary votes and reappropriations. The States in certain cases have to obtain the approval of the Federal Finance Minister to their financial measures. The Federal government thus keeps a watch and controls the financial system of the whole country. In Australia the Finance Ministers of the Commonwealth and the States have an opportunity of joint deliberation over the budgets of the Federal and the State governments in conferences held for the purpose. This brings about the necessary measure of co-operation among the States under the advice of the Commonwealth Government. A general supervision over the budgets of the states may thus be conceded to the federal government in the interest of national economy. It should facilitate the federal government to lay out its programme of

ways and means and loans, and to determine its banking and currency policy on the basis of sound information and in the interest of the nation as a whole.

Closely allied to budgetary co-ordination is the question of the audit of accounts. The principle of the independence of audit demands that the audit of accounts all over the country should be conducted by officers who are responsible only to the supreme legislative council, and who cannot be removed from their posts except for grave fault or incompetence. Each unit should, nevertheless, have an efficient department of accounting with a system of internal and local audit. In India, under the scheme of the separation of accounts and audit, the Provinces have their own payment offices and accounts departments. But the audit of these accounts is conducted by the central Audit Department controlled by the Auditor-General, whose appointment and tenure of office are on the same basis as those of the judges of the Supreme Court, and whose decisions in matters of audit are final. As the ties of federation draw closer later on, the States may also join the system of independent central audit. In matters of financial adjudication, as well as the centralisation of the financial machinery, Germany has evolved an efficient system. On the administrative side there are finance offices in each district (Finanzamt),

and State (Landesfinauzamt). They are controlled by the Federal Finance Ministry (Reichsfinanzministerium). The local finance office, with a director at its head, enables the local bodies to take their part in the assessment of taxes. The municipal police may be called upon by the local finance office to render assistance in financial administration. The State finance office supervises the work of the local offices and provides for the equitable application of tax laws. The Federal Finance Ministry is the apex of the system with the ultimate power of superintendence and direction. Matters relating to the interpretation of fiscal laws are decided by the finance courts, which control the legal side of finance. There is a finance court (Fizanzgericht) in each State composed of two classes of members, professional and lay, and presided over by a person who has the double experience of law and finance. Legal problems connected with finance are not decided by ordinary courts, but are taken to the finance courts, from which an appeal lies to the Federal Finance Court (Reichsfinanzhof) at Munich. The financial courts enjoy the independence of the ordinary judiciary and the decisions of the Federal finance court are final. The case law developed by these courts decides the future interpretation and evolution of the fiscal regulations.

Thus in Germany the financial machinery has

been centralised to a very considerable extent. In Australia, also, a sufficient measure of co-ordination in State finances is achieved by the Ministerial Conferences. In the United States and Switzerland constitutional changes have not kept pace with the centralising tendencies in modern economic life in order to put up a structure for financial co-operation over and above the barriers of State and local jurisdictions. The need for co-ordination is, however, recognised by the creation of State tax commissions and equalisation boards for the assessment of property in several States in America.

In dealing with problems of administrative efficiency and economy in a federation, it is necessary to distinguish between the centralisation of procedure and the concentration of authority. The former does not essentially involve the latter. The states may retain all their financial competence under a scheme of co-ordination in procedure and co-operation in activities. It need not affect their ultimate powers of taxation and expenditure.

PART IV
Problems of Loans

CHAPTER XI

PUBLIC LOANS IN A FEDERATION

THE ordinary expenditure of a state in normal times is met from revenue raised by taxation. In cases of emergency like war, the state resorts to public borrowing to provide for the extraordinary expenses involved. Loans are raised again to finance a programme for the development of the country and for heavy capital expenditure.

Since changes in taxation always involve disturbance, it is necessary to maintain the rates of taxation as constant as possible from year to year. If the expenditure of the state varies within narrow limits, it is desirable to make a deficit in one year balance a surplus in another. Hence the state borrows to a certain extent, even for its normal expenditure, to avoid temporary changes in the scheme of taxation.

A justification of the financing of public expenditure on capital and development activities has been sought, in the argument that the ultimate benefit of such expenditure is received by the coming generations who should bear its burden, and that if it is financed by public loans the burden is transferred to posterity.

As Professor Pigou has pointed out,[1] there are several qualifications for this argument. Finance by loans does not hit capital and therefore the economic fortunes of future generations are affected somewhat more by loans than by taxes. The stronger reason, however, for a community to raise loans to finance its development expenditure, is that it should apportion its income between consumption for present needs and investment. A community which does not save to increase its capital equipment will lag behind and will be unable to derive full benefit from future improvements in methods of economic production. The norm of time-preference thus operates to prevent the consumption of the whole national income for present requirements.

The expenditure incurred for the development of a country may be "productive" or "unproductive." Capital outlay which pays its way, has an evident justification. But expenditure which does not bring in a visible or immediate return, may have ultimate indirect benefits. In a country like Australia, where the possibilities of economic development were vast, heavy expenditure has been incurred by public borrowing, resulting in a considerable increase in national welfare. Professor Bastable has said, "Non-economic (i.e. non-remunerative) expenditure is primarily to

[1] "Public Finance," p. 237–242.

be met out of income, and unless it can be so dealt with ought not to be incurred." But in cases where the development of the economic resources of the country demands heavy expenditure, public loans may be justified. To a certain extent finance by loans may supplement the ordinary revenue of a government even for its normal expenditure, if it is necessary to avoid temporary changes in the rates of taxation. This arrangement must be subject to adjustment from year to year, unless a longer period was necessary as in the case of Austria, which owing to a sudden disaster had to meet its normal expenditure by loans for several years.

It is, of course, always necessary to restrict the amount of borrowing according to the prospect of immediate adjustment, or to the nature and size of indirect benefit that may accrue in the case of development expenditure. If public expenditure is financed by loans irrespective of these considerations, the future resources of the country and its future prosperity may be too heavily mortgaged, resulting in economic injury and a breakdown of the financial system.

The power to borrow is enjoyed by federal and state governments, in conjunction with their powers of taxation. It has been conceded as an attribute of financial authority and while the powers of taxation have been scrupulously divided

between the federal and state governments, their powers to raise money by loans have generally been plenary and concurrent. In the United States, the constitution did not take away the borrowing powers of the States, and any restrictions that exist have been self-imposed by the States through their constitution. The States borrowed freely before the collapse of 1837. The Western and Southern States raised public loans to finance internal improvements until they received a check by the crisis of 1857. The advent of the motor highway opened a new era of State borrowing and the total indebtedness of the States reached, in 1928, $1,502,000,000. The Federal government has, however, since 1870 followed a policy of reducing Federal debt from current surpluses. Between 1917 and 1920 it borrowed over twenty-five billion dollars for purposes of the War. But refunding operations have continued and a large part of the War Debt has been retired. The Federal debt in 1919 stood at $26,594,000,000, and in 1930 only at $15,921,000,000. During the period of the New Deal, however, Congress voted huge appropriations with a lavish hand and the Federal treasury provided the additional funds by borrowing.

In India, the powers of the Provinces to borrow is subject to two limitations. The consent of the Federal government will be necessary for a Province if it borrows outside India, or if it borrows when

there is still outstanding a part of the loan made to it by the Federal government, or guaranteed by the Federal government. The Governor-General in his personal capacity has been given a special responsibility regarding the financial credit of India. In the matter of these "financial safeguards" he will be assisted by a financial adviser. The Governor-General may, when he deems it necessary, impose restrictions regarding the credit operations of the Provinces in the exercise of his special personal responsibility.

In Brazil, a guarantee of the Federal government is necessary to the raising of loans by the States. In the Union of South Africa, the Provinces have in theory the power to borrow in the market, but all their loans have come from the Union Treasury, which thus controls their loan operations.

The evils that may result from an unrestricted exercise of borrowing powers by competing authorities do not exist in cases where the debts of the units have been assumed by the federal government. In Canada, for example, the various Provinces were indebted in 1864, as follows :

Province of Canada . .	26.83
Nova Scotia . . .	14.38
New Brunswick . . .	23.02
Newfoundland . . .	7.27
Prince Edward Island . .	2.97
All the Provinces . .	23.94

The public debt of the Provinces was incurred mainly for public works which had inter-state importance. On the assumption of the debts, the Dominion Government took over the assets of these public works and the control of the inter-provincial public works administration. The debts of the Provinces did not in any way correspond to their respective populations or their revenue paying capacity. Hence a *per capita* basis was adopted in assessing the burden of the debts. Each Province was allowed a debt of $25 per head of its population. If its public debt was more than the debt thus "allowed," it had to pay an interest of 5 per cent. on the excess to the Dominion Government from the date of its transfer. If its debt was less than the calculated "allowed debt," the Dominion Government was to pay it interest at the same rate on the amount of the deficiency. This arrangement has been modified several times in order to remove inequalities. New Provinces were allowed similar concessions on their entry to the federation. Manitoba in 1870, British Columbia in 1871, and Prince Edward Island in 1873 joined the federation, transferring their debts on the *per capita* basis. In 1873 the Dominion Government assumed the interest paying excess of Ontario and Quebec, and made proportional increases for the other Provinces. The concessions on account of the "allowed debt" continued till 1905, when the amount of the

assumed debt rose up to $125 millions. Since then the Provinces have received assistance from the Dominion Government in other forms of subsidies and compensation for crown lands.

In Australia, the aggregate debt of the Commonwealth and the States increased from £200 millions in 1901 to £1,104 millions in 1929. Nearly two-thirds of the increase in the debt is due to expenditure for purposes of economic development, for capital expenditure on railways, tramways, water supply, land settlement, harbours, posts, telegraphs, telephones, public buildings and irrigation.

The loans were raised at high rates of interest in the London market. The reason for the difficulty in obtaining loans and their high rates of interest is to be found not only in economic factors of world importance, but also in the financial position of Australia itself. The share of the States in the development loans was fourteen times as large as that of the Commonwealth. They did not make adequate provisions of sinking funds for these loans. The combined expenditure of the Commonwealth and the States for debt service was £33 millions in 1919–20 and £61 millions in 1928–29, or 29 per cent. and 32 per cent. respectively of the total expenditure. The States resorted to an extension of their tax systems to raise the additional revenue required and often came in conflict with the tax jurisdiction of the Common-

wealth. The situation was aggravated when several of the loans matured for repayment, and Australian exports suffered on account of falling prices of her primary products.

In 1923 the Loan Council was established to bring about order in the credit operations of the country. It was laid down that every proposal for loan should be sanctioned by the Loan Council, which examines the necessity, the objects and the size of the loan. Adequate provisions are made for sinking funds and borrowing is done by the Commonwealth Government. The loans are raised in London and New York on better rates of interest, owing to the absence of competition and the Commonwealth guarantee involved. In 1929, by the Financial Agreement Validation Act, the Commonwealth assumed charge of the State debts in lieu of the payment of *per capita* subsidies. It pays interest on the public debt and provides for a common sinking fund.

In India, the Federal government representing the Provinces and the States, will assume charge of the public debt of the central government. The total amount of interest-bearing obligations of the central government in March, 1935, stood at Rs.203.19 crors. They are not covered by any interest yielding assets or cash or bullion held on treasury account. The public debt has been incurred mainly for the benefit of the territory

covered by the Provinces. It has been suggested that the burden of the service of this debt should lie exclusively on the Provinces, and that "the Federation should start with a clean sheet." It is impracticable to search for a basis for the allocation of the central debt among the Provinces. There is, on the other hand, every reason to entrust the service and the control of the public debt to the Federal government in the interest of the maintenance of the credit of the Federation. The States have received certain indirect benefits from loan expenditure on the development of the country. They may, therefore, partake in the service of the debt. But as their share in the cost of the debt service should be proportionate only to the indirect advantage received, their equal participation in the Federal tax scheme may be set off by a Federal subvention. The amount of the Federal subvention should be determined with reference to the size of the State, the nature of the benefit received and the revenue paid by it through Federal taxes.

The experience of unrestricted borrowing by state and local authorities in the United States, Australia and the Latin American Federations, emphasises the necessity of a joint control of the loan policy in a federal state. In Mexico, Brazil and Argentina, the ever-increasing indebtedness of the subordinate authorities and their failure to meet their obligations have involved the federal

governments in international difficulties. In the United States, during the first half of the nineteenth century, several States had underwritten the bonds of railway and canal companies which subsequently collapsed, leaving the State governments saddled with heavy indebtedness. This forced many of them to introduce in their constitutions limitations as to the size and nature of their loans. Some States prescribed a maximum for the debt that may be allowed to be outstanding at any time. Others restrict the size of their public debt to a fixed ratio to the assessment value of the total property within their territories. Some others have laid down the purposes for which alone a loan may be raised. A few States require the loan proposals to be put to the test of referendum, while most of them forbid any lending of credit to private corporations.[1]

In Australia, prior to the establishment of the Loan Council, the States have competed with each other in borrowing in the open market, thus raising the rate of interest. Loans have been raised with little regard to the interest of the country as a whole. The failure of New South Wales to meet its obligations demonstrated the need of controlling the activities of the states if political difficulties were to be avoided.

The Australian Loan Council[2] presents a model

[1] Schultz: "American Public Finance and Taxation."

[2] See Appendix II for the details of its constitution.

for a joint control of loans in a federation. The method of making constitutional limitations, as in the United States, is unwieldy and insufficient for a day to day examination, management and provision of public loans. A joint control of loan operations in a federation enhances the credit of the country and enables it to raise loans at the most favourable time and at the best rate of interest. The existence of a common authority for raising loans, facilitates the examination of the loan programmes of the several governments. The soundness of their projects may be verified before the loans are floated. A maximum may be prescribed to the total indebtedness of the federation and the states. If the amount of loans that may be raised in a year does not correspond to the demands of the states, a " rationing " may be carried out based on the relative urgency, productivity and financial stability of the states. The loan programme may be worked out with a view to a harmonious development of the whole country.

The common borrowing authority can study the loan market and decide between the advantages of floating a loan at home or abroad, keeping in view the amount of credit available in the country. The responsibility for the repayment of the debt should rest with the particular government requiring the loan for its expenditure. Payments

on account of interest and capital should be a charge on the revenues of the government concerned, and the common authority should be able to prescribe the necessary provisions for sinking funds. It is, therefore, necessary that the joint body for the control of loans should not merely be a consultative body but should have governmental authority. It should enjoy the independent status of a reserve bank and its decisions should be binding. A mere consultative body will not command much credit. It will be able to perform its functions efficiently if its decisions carry the authority and its loans enjoy the guarantee of the federal government.

Appendices

APPENDIX I

LEGISLATIVE LISTS OF THE FEDERATION IN INDIA

List I

Federal Legislative List

1. His Majesty's naval, military and air forces borne on the Indian establishment and any other armed force raised in India by the Crown, not being forces raised for employment in Indian States or military or armed police maintained by provincial governments; any armed forces which are not forces of His Majesty, but are attached to or operating with any of His Majesty's naval, military or air forces borne on the Indian establishment; central intelligence bureau; preventive detention in British India for reasons of state connected with defence, external affairs, or the discharge of the functions of the Crown in its relations with Indian States.

2. Naval, military and air force works; local self-government in cantonment areas (not being cantonment areas of Indian State troops), the regulation of house accommodation in such areas,

and, within British India, the delimitation of such areas.

3. External affairs; the implementing of treaties and agreements with other countries; extradition, including the surrender of criminals and accused persons to parts of His Majesty's dominions outside India.

4. Ecclesiastical affairs, including European cemeteries.

5. Currency, coinage and legal tender.

6. Public debt of the federation.

7. Posts and telegraphs, including telephones, wireless, broadcasting, and other like forms of communication; post office savings bank.

8. Federal public services and federal public service commission.

9. Federal pensions, that is to say, pensions payable by the federation or out of federal revenues.

10. Works, lands and buildings vested in, or in the possession of, His Majesty for the purposes of the federation (not being naval, military or air force works), but, as regards property situate in a province, subject always to provincial legislation, save in so far as federal law otherwise provides, and, as regards property in a federated state held by virtue of any lease or agreement with that state, subject to the terms of that lease or agreement.

11. The Imperial Library, the Indian Museum,

the Imperial War Museum, the Victoria Memorial, and any similar institution controlled or financed by the federation.

12. Federal agencies and institutes for the following purposes, that is to say, for research, for professional or technical training, or for the promotion of special studies.

13. The Benares Hindu University and the Aligarh Muslim University.

14. The Survey of India, the Geological, Botanical and Zoological Surveys of India; federal meteorological organisations.

15. Ancient and historical monuments; archæological sites and remains.

16. Census.

17. Admission into, and emigration and expulsion from, India, including in relation thereto the regulation of the movements in India of persons who are not British subjects domiciled in India, subjects of any federated state, or British subjects domiciled in the United Kingdom; pilgrimage to places beyond India.

18. Port quarantine; seamen's and marine hospitals, and hospitals connected with port quarantine.

19. Import and export across customs frontiers as defined by the federal government.

20. Federal railways; the regulation of all railways other than minor railways in respect of

safety, maximum and minimum rates and fares, station and service terminal charges, interchange of traffic and the responsibility of railway administrations as carriers of goods and passengers; the regulation of minor railways in respect of safety and the responsibility of the administrations of such railways as carriers of goods and passengers.

21. Maritime shipping and navigation, including shipping and navigation on tidal waters; Admiralty jurisdiction.

22. Major ports, that is to say, the declaration and delimitation of such ports, and the constitution and powers of port authorities therein.

23. Fishing and fisheries beyond territorial waters.

24. Aircraft and air navigation; the provision of aerodromes; regulation and organisation of air traffic and of aerodromes.

25. Lighthouses, including lightships, beacons and other provision for the safety of shipping and aircraft.

26. Carriage of passengers and goods by sea or by air.

27. Copyright, inventions, designs, trademarks and merchandise marks.

28. Cheques, bills of exchange, promissory notes and other like instruments.

29. Arms; firearms; ammunition.

30. Explosives.

31. Opium, so far as regards cultivation and manufacture, or sale for export.

32. Petroleum and other liquids and substances declared by federal law to be dangerously inflammable, so far as regards possession, storage and transport.

33. Corporations, that is to say, the incorporation, regulation and winding-up of trading corporations, including banking, insurance and financial corporations, but not including corporations owned or controlled by a federated state and carrying on business only within that state or co-operative societies, and of corporations, whether trading or not, with objects not confined to one unit.

34. Development of industries, where development under federal control is declared by federal law to be expedient in the public interest.

35. Regulation of labour and safety in mines and oilfields.

36. Regulation of mines and oilfields and mineral development to the extent to which such regulation and development under federal control is declared by federal law to be expedient in the public interest.

37. The law of insurance, except as respects insurance undertaken by a federated state, and the regulation of the conduct of insurance business, except as respects business undertaken by a federated state; government insurance, except so

far as undertaken by a federated state, or, by virtue of any entry in the Provincial Legislative List or the Concurrent Legislative List, by a province.

38. Banking, that is to say, the conduct of banking business by corporations other than corporations owned or controlled by a federated state and carrying on business only within that state.

39. Extension of the powers and jurisdiction of members of a police force belonging to any part of British India to any area in another governor's province or chief commissioner's province, but not so as to enable the police of one part to exercise powers and jurisdiction elsewhere without the consent of the government of the province or the chief commissioner, as the case may be, extension of the powers and jurisdiction of members of a police force belonging to any unit to railway areas outside that unit.

40. Elections to the Federal Legislature, subject to the provisions of this Act and of any Order in Council made thereunder.

41. The salaries of the federal ministers, of the President and Vice-President of the Council of State and of the Speaker and Deputy Speaker of the Federal Assembly; the salaries, allowances and privileges of the members of the Federal Legislature; and, to such extent as is expressly

authorised by Part II of this Act, the punishment of persons who refuse to give evidence or produce documents before committees of the Legislature.

42. Offences against laws with respect to any of the matters in this list.

43. Inquiries and statistics for the purposes of any of the matters in this list.

44. Duties of customs, including export duties.

45. Duties of excise on tobacco and other goods manufactured or produced in India except:

(*a*) alcoholic liquors for human consumption;
(*b*) opium, Indian hemp and other narcotic drugs and narcotics; non-narcotic drugs;
(*c*) medicinal and toilet preparations containing alcohol, or any substance included in sub-paragraph (*b*) of this entry.

46. Corporation tax.

47. Salt.

48. State lotteries.

49. Naturalisation.

50. Migration within India from or into a governor's province or a chief commissioner's province.

51. Establishment of standards of weight.

52. Ranchi European Mental Hospital.

53. Jurisdiction and powers of all courts, except the Federal Court, with respect to any of the matters in this list and, to such extent as is expressly authorised by Part IX of this Act, the enlargement of the appellate jurisdiction of the

Federal Court, and the conferring thereon of supplemental powers.

54. Taxes on income other than agricultural income.

55. Taxes on the capital value of the assets, exclusive of agricultural land, of individuals and companies; taxes on the capital of companies.

56. Duties in respect of succession to property other than agricultural land.

57. The rates of stamp duty in respect of bills of exchange, cheques, promissory notes, bills of lading, letters of credit, policies of insurance, proxies and receipts.

58. Terminal taxes on goods or passengers carried by railway or air; taxes on railway fares and freights.

59. Fees in respect of any of the matters in this list, but not including fees taken in any court.

List II

Provincial Legislative List

1. Public order (but not including the use of His Majesty's naval, military or air forces in aid of the civil power); the administration of justice; constitution and organisation of all courts, except the Federal Court, and fees taken therein; preventive detention for reasons connected with the

maintenance of public order; persons subjected to such detention.

2. Jurisdiction and powers of all courts except the Federal Court, with respect to any of the matters in this list; procedure in Rent and Revenue Courts.

3. Police, including railway and village police.

4. Prisons, reformatories, borstal institutions and other institutions of a like nature, and persons detained therein; arrangements with other units for the use of prisons and other institutions.

5. Public debt of the province.

6. Provincial public services and provincial public service commissions.

7. Provincial pensions, that is to say, pensions payable by the province or out of provincial revenues.

8. Works, lands and buildings vested in or in the possession of His Majesty for the purposes of the province.

9. Compulsory acquisition of land.

10. Libraries, museums and other similar institutions controlled or financed by the province.

11. Elections to the Provincial Legislature, subject to the provisions of this Act and of any Order in Council made thereunder.

12. The salaries of the provincial ministers, of the Speaker and Deputy Speaker of the Legislative Assembly, and, if there is a Legislative Council,

of the President and Deputy President thereof; the salaries, allowances and privileges of the members of the Provincial Legislature; and, to such extent as is expressly authorised by Part III of this Act, the punishment of persons who refuse to give evidence or produce documents before committees of the Provincial Legislature.

13. Local government, that is to say, the constitution and powers of municipal corporations, improvement trusts, district boards, mining settlement authorities and other local authorities for the purpose of local self-government or village administration.

14. Public health and sanitation; hospitals and dispensaries; registration of births and deaths.

15. Pilgrimages, other than pilgrimages to places beyond India.

16. Burials and burial grounds.

17. Education.

18. Communications, that is to say, roads, bridges, ferries, and other means of communication not specified in List I; minor railways subject to the provisions of List I with respect to such railways; municipal tramways; ropeways; inland waterways and traffic thereon subject to the provisions of List III with regard to such waterways; ports, subject to the provisions in List I with regard to major ports; vehicles other than mechanically propelled vehicles.

19. Water, that is to say, water supplies, irrigation and canals, drainage and embankments, water storage and water power.

20. Agriculture, including agricultural education and research, protection against pests and prevention of plant diseases; improvement of stock and prevention of animal diseases; veterinary training and practice; pounds and the prevention of cattle trespass.

21. Land, that is to say, rights in or over land, land tenures, including the relation of landlord and tenant, and the collection of rents; transfer, alienation and devolution of agricultural land; land improvement and agricultural loans; colonization; courts of wards; encumbered and attached estates; treasure trove.

22. Forests.

23. Regulation of mines and oilfields and mineral development, subject to the provisions of List I, with respect to regulation and development under federal control.

24. Fisheries.

25. Protection of wild birds and wild animals.

26. Gas and gasworks.

27. Trade and commerce within the province; markets and fairs; money lending and money lenders.

28. Inns and inn-keepers.

29. Production, supply and distribution of goods;

development of industries, subject to the provisions in List I, with respect to the development of certain industries under federal control.

30. Adulteration of foodstuffs and other goods; weights and measures.

31. Intoxicating liquors and marcotic drugs, that is to say, the production, manufacture, possession, transport, purchases and sale of intoxicating liquors, opium and other narcotic drugs, but subject, as respects opium, to the provisions of List I, and, as respects poisons and dangerous drugs, to the provisions of List III.

32. Relief of the poor; unemployment.

33. The incorporation, regulation, and winding-up of corporations other than corporations specified in List I; unincorporated trading, literary, scientific, religious and other societies and associations; co-operative societies.

34. Charities and charitable institutions; charitable and religious endowments.

35. Theatres, dramatic performances and cinemas, but not including the sanction of cinematograph films for exhibition.

36. Betting and gambling.

37. Offences against laws with respect of any of the matters in this list.

38. Inquiries and statistics for the purpose of any of the matters in this list.

39. Land revenue, including the assessment and

collection of revenue, the maintenance of land records, survey for revenue purposes and records of rights, and alienation of revenue.

40. Duties of excise on the following goods manufactured or produced in the province and countervailing duties at the same or lower rates on similar goods manufactured or produced elsewhere in India :

(*a*) Alcoholic liquors for human consumption ;
(*b*) opium, Indian hemp and other narcotic drugs and narcotics ; non-narcotic drugs ;
(*c*) medicinal and toilet preparations containing alcohol or any substance included in sub-paragraph (*b*) of this entry.

41. Taxes on agricultural income.

42. Taxes on lands and buildings, hearths and windows.

43. Duties in respect of succession to agricultural land.

44. Taxes on mineral rights, subject to any limitations imposed by any Act on the Federal Legislature relating to mineral development.

45. Capitation taxes.

46. Taxes on professions, trades, callings and employments.

47. Taxes on animals and boats.

48. Taxes on the sale of goods and on advertisements.

49. Cesses on the entry of goods into a local area for consumption, use or sale therein.

50. Taxes on luxuries, including taxes on entertainments, amusements, betting and gambling.

51. The rates of stamp duty in respect of documents other than those specified in the provisions of List I with regard to rates of stamp duty.

52. Dues on passengers and goods carried on inland waterways.

53. Tolls.

54. Fees in respect of any of the matters in this list, but not including fees taken in any court.

List III

Concurrent Legislative List

Part I

1. Criminal law, including all matters included in the Indian Penal Code at the date of the passing of this Act, but excluding offences against laws with respect to any of the matters specified in List I or List II and excluding the use of His Majesty's naval, military and air forces in aid of the civil power.

2. Criminal procedure, including all matters included in the Code of Criminal Procedure at the date of the passing of this Act.

3. Removal of prisoners and accused persons from one unit to another unit.

4. Civil Procedure, including the law of limita-

tion and all matters included in the Code of Civil Procedure at the date of the passing of this Act; the recovery in a Governor's province or a Chief Commissioner's province of claims in respect of taxes and other public demands, including arrears of land revenue and sums recoverable as such, arising outside that province.

5. Evidence and oaths; recognition of laws, public acts and records and judicial proceedings.

6. Marriage and divorce; infants and minors; adoption.

7. Wills, intestacy, and succession, save as regards agricultural land.

8. Transfer of property other than agricultural land; registration of deeds and documents.

9. Trusts and trustees.

10. Contracts, including partnership, agency, contracts of carriage, and other special forms of contract, but not including contracts relating to agricultural land.

11. Arbitration.

12. Bankruptcy and insolvency; administrators-general and official trustees.

13. Stamp duties other than duties or fees collected by means of judicial stamps, but not including rates of stamp duty.

14. Actionable wrongs, save in so far as included in laws with respect to any of the matters specified in List I or List II.

15. Jurisdiction and powers of all courts, except the federal court, with respect to any of the matters in this list.

16. Legal, medical and other professions.

17. Newspapers, books and printing presses.

18. Lunacy and mental deficiency, including places for the reception or treatment of lunatics and mental deficients.

19. Poisons and dangerous drugs.

20. Mechanically propelled vehicles.

21. Boilers.

22. Prevention of cruelty to animals.

23. European vagrancy; criminal tribes.

24. Inquiries and statistics for the purpose of any of the matters in this part of this list.

25. Fees in respect of any of the matters in this part of this list, but not including fees taken in any court.

PART II

26. Factories.

27. Welfare of labour; conditions of labour; provident funds; employers' liability and workmen's compensation; health insurance, including invalidity pensions; old age pensions.

28. Unemployment insurance.

29. Trade unions; industrial and labour disputes.

30. The prevention of the extension from one

unit to another of infectious or contagious diseases or pests affecting men, animals or plants.

31. Electricity.

32. Shipping and navigation on inland waterways as regards mechanically propelled vessels, and the rule of the road on such waterways; carriage of passengers and goods on inland waterways.

33. The sanctioning of cinematograph films for exhibition.

34. Persons subjected to preventive detention under federal authority.

35. Inquiries and statistics for the purpose of any of the matters in this part of this list.

36. Fees in respect of any of the matters in this part of this list, but not including fees taken in any court.

APPENDIX II

FINANCES OF A UNION OF INDEPENDENT STATES: THE LEAGUE OF NATIONS

A

Is the League of Nations a Federation?

A federation is a collection of separate states organized under a central authority with the following two-fold implication:

(1) That the central authority is not immediately dependent upon the states for the enforcement of its decisions, and

(2) That the states do not lose their identity in submitting to the authority of the central power. The central or federal power, that is to say, must have an independent machinery with which to make its authority unquestioned and unchallengable within its territory. In an orthodox federation, the U.S.A., for instance, such a machinery is the federal executive with its own civil service, and its armed forces. On the other hand, the various states require a safeguard for maintaining their independent personality. They find it in the existence of an independent judicial tribunal

which has the power to veto an unjustifiable exercise of federal power. This judicial tribunal maintains the delicate balance between state independence and federal authority through the instrumentality of the federal constitution that prescribes the limits within which both the federal and state authorities are to exercise their power. The supreme court or the judicial tribunal exercises its functions by doing nothing more than declaring the will of the constitution.[1] The only way in

[1] A literal interpretation of the constitution, while satisfying the norms of legalism, fails to consider the new environmental factors of the present century. Since President Roosevelt came to office in March, 1933, his efforts to ameliorate industrial and agricultural conditions in the United States have failed simply because the Fathers of the Constitutions did not foresee the present situation and did not provide for it in the Constitution. The N.R.A. was declared unconstitutional on May 27, 1935, and the A.A.A. on January 6, 1936. Mr. Justice Roberts in the course of his judgment in the latter said that "Congress has no power to enforce its commands on the farmer to the ends sought by the Agricultural Adjustment Act. . . . The Constitution and the entire plan of our government negative any such use of the power to tax and to spend as the Act undertakes to authorize." (United States *v.* Butler.)

Further Mr. Justice Cardozo concurring with C. J. Hughes in invalidating the N.R.A. says bluntly that the Constitution did not authorize "the regulation of wages and hours of labour" by the Congress, and he adds his personal opinion that "if centripetal forces are to be isolated to the exclusion of the forces that oppose and counteract them, there will be an end to our Federal system." (Schechter *v.* United States.) 295 U.S., 554, 555.

which either the state or the federal authorities can have their own way against judicial opposition or veto is by an amendment of the constitution, which is usually made as difficult as possible in order to prevent hasty thinking as also to make the area of its consent as wide as possible.

The above review makes it clear that it is not merely the legal instrument or the constitution that makes a federation, but also its substance, and of the substance the following may be cited as characteristics :

I. A federation must have an executive that is not derived directly from the governments of the states but has an independent origin.

II. The federal executive must have its own civil service.

III. The federal executive must be in complete control of the armed forces of the federation.

IV. The federation must have certain sources of revenue for which it is not dependent upon the will of the component states.

Whether the League of Nations is a federation or not is a question that must be analysed in the perspective of these four characteristics.

I. The first point, viz. that the executive of a federation must not be derived from the governments of the states but must have an independent origin, is clear in such cases as, for instance, the U.S.A. or Australia. The American President

represents the people; and even the Senate has little connection with the respective governments of the States since the XVII amendment. Their national origin makes it possible for the federal government to view the whole federation as one unit and not as a conglomeration of separate states. This is fatally lacking in the League machinery. Article III of the Covenant provides that the Assembly shall consist of the "Representatives of the Members of the League." Members, of course, here signify the governments of the various states. Each representative of the member goes to the Assembly as a servant of his government, not with the avowed object of improving the world, but getting as many concessions as possible for his government. Besides, although each member is permitted to send three delegates to the assembly, it may have only one, and not more than one, vote.[1] The principle of separatism is, therefore, rigidly preserved.

A. F. Pollard, as early as 1918, interpreted this sentiment when he said that "internationalism implies nationalism" and that what is needed is "an inter-state rather than a super-state,[2] because, as he added elsewhere,[3] "nationality has come to

[1] Art. III.

[2] A. F. Pollard: "The League of Nations, An Historical Argument," p. 10.

[3] A. F. Pollard: "The League of Nations in History," p. 12.

stay, and the purport of the League of Nations is to provide means for the expression of nationality." Nothing does this so much as the unanimity rule in the procedure of the assembly and the council. It is pointed out in some quarters that if A, B, C, etc., must *All* agree before they can take a particular course of action, then they can as well do it outside as inside the League—the fact that the more powerful nations usually dominate the League deliberations does not invalidate this argument, because the more powerful nations always dominate, League or no League. An institution which systematises their domination is consequently no better than perhaps an improved picture of the Congress of Vienna (1815–22), and Professor Zimmern's frank preference for an arrangement like the Four Power Pact[1] is in that light quite intelligible.

The first condition of a federation, therefore, does not exist in the League of Nations.

II. The Federal Executive must have its own Civil Service. Superficially the League is seen to fulfil this condition, but not when an analysis is made of the purposes for which its civil service exists. These purposes are more or less related to the activities of the Council and Assembly. In the U.S.A. one of the important functions of the Federal

[1] Professor Zimmern: "The League of Nations and The Rule of Law, 1918–1935," p. 411.

civil service is to collect federal taxes; and since 1933, of course, a great deal of its energies have been spent in carrying out the work of the new administration. A few precedents in the constitutional history of the U.S.A. have established the rule that since Federal officers "must act within the States"[1] they must not, when carrying out their Federal duties, be prevented from doing so by the respective States. Here is another principle which admits the necessity of Federal supremacy. The civil service of the League of Nations, however, does not enjoy such governmental supremacy over any wide range of functions.

What this makes plain is that the League lacks an independent source of income, and this diminishes the political status it may attain, owing to the fascination of its principle. The League has no taxes to collect. At some stage in the future, if the League is at all to improve from the position of a "joint stock corporation," it will have to possess independent means of income.

III. Control of the army is without doubt the key to the supremacy of the federation over its members. The existence of an independent source of revenue to finance the army is of course necessary, for the co-operation of the army has always been a decisive factor in any form of state activity.

In reviewing the League from this angle a query

[1] Tennessee *v.* Davis (1879) 100, U.S. 257.

arises. Why are the respective states of a federation willing to yield complete control of the army to the central authority? The answer to this lies in their motive in joining the federal union. The union is formed to provide common defence and guard against external aggression as well as to attain economic stability in interstate relationship. Where is this defence against external aggression in the case of the League of Nations which, in theory, seeks to control the whole world? The question cannot arise at any rate if the League *is* a League of *all* nations.[1] But so long as the League is not sovereign itself it will fail in its ends of being an international government which can *enforce* peace within its jurisdiction. At present peace is enforced through the League machinery only by those governments that at a particular moment may derive an advantage—or at least may not suffer harm—through the operation of that machinery. The unwillingness of the British Government to set moving the League machinery in the Sino-Japanese dispute is in that light intelligible, so also the half-hearted and listless behaviour of France in the Italo-League-Abyssinian affair. It is further not surprising to study the reaction upon France of the Hitler coup in remilitarising the Rhineland. Vaguely oblivious of her distrust

[1] See G. C. Butler's "A Handbook to the League of Nations," Part II, Chapter XIII, for a discussion of this problem.

of sanctions in case of Italy she now insists upon them in case of Germany.

If the League is to approximate the principle of defence in a federation it must have an army of its own or at any rate a police force. It must not again depend upon the voluntary contributions of its members for the maintenance of that force.

IV. The Federation must have certain sources of revenue for which it is not dependent upon the will of the component states. The importance of this point has already been explained above.

The four characteristics discussed above are essential to federalism and the more the League enjoys them the more it will advance towards being a real super-state.

B

The Finances of the League of Nations

The above has been in the nature of a digression, as the essential purpose of this Appendix is to discuss the financial structure of the League. But in justification it may be pointed out that it is necessary to examine the nature of the institution in order to study its financial system.

The League in its present form, not being a government with varied functions, its financial structure does not bear complete analogy to the system of public finance in an ordinary state. It has, of course, its revenue, its expenditure, and its

debt, but they are all confined to administrative charges associated with the League Secretariat, the meetings of the Council and Assembly or the activities of the I.L.O. and the Hague Court. The average annual expenditure of the League is about a million pounds. All contributions are voluntary and are therefore liable to cease under certain circumstances.

Basis of Allocation

When the League was formed in 1919 none of the States who joined had any definite idea of how to regulate its finances and specially how to distribute the burden of its expenditure. The conception of the League as a federation had been ruled out as impracticable at that stage. The implications of federal finance could therefore offer no guidance to the drafters of the Covenant in determining the League financial structure. The only parallel would be a voluntary organization and the only voluntary organization of international importance they could think of at the moment was the Universal Postal Union. It was therefore determined that paragraph 5 of Article 6 should run as follows: "The expenses of the Secretariat shall be borne by the Members of the League in accordance with the apportionment of expenses of the International Bureau of the Universal Postal Union."

The first organization of this kind was the

International Telegraphic Convention (1868). Following a conference held at Berne in 1874 the "Universal Postal Union" emerged, adopting the same scale as the I.T.C. for the apportionment of its expenses. According to this scale each member state is given a classification [1] in the following way:

Class I	Units 25	Amount	£16,234
Class II	Units 20	Amount	£12,960
Class III	Units 15	Amount	£9,742
Class IV	Units 10	Amount	£6,494
Class V	Units 5	Amount	£3,247
Class VI	Units 3	Amount	£1,948

In 1890 a seventh class, rated at one unit (amount £648), was added at the request of the smaller states.[2]

The League of Nations had not been the first to adopt this scale. For the offices of the Permanent Court of Arbitration at the Hague—result of the Conventions of 1899 and 1907—this scale was adopted to apportion expenses. In the case of the Universal Postal Union the general principle followed in arriving at the classification of a state was "according to the population, extent of territory, and the importance of the postal traffic." That obviously could not, in all essentials, apply to

[1] See the little pamphlet published by the L. of N. Information Section in 1928 entitled "Financial Administration and Apportionment of Expenses."

[2] *Ibid.*, p. 22.

the League of Nations, as the " importance of postal traffic " has little relation to the political status of a state. Besides, the budget of the League was found to be much larger than that of the Universal Postal Union. The annual expenditure of the latter was roughly £5,000, divided among 81 contributors.[1] This sum is too small to be a problem, but the budget figure of the League is high enough to raise the problem of equity in the allocation of expenditure. This was specially manifest until the scale of the U.P.U. was repealed in favour of a scale to be decided by the Assembly from time to time.

Under the scale of the U.P.U., for instance, India paid the same amount as the British Empire, viz. £16,234, both being in the first class, so were China, Japan and Poland. It could not for a moment be argued that all these countries had the same potential wealth as to justify an equality in their contributions.

These drawbacks were clear in 1920, when at its August meeting in San Sebastian the League Council arranged the constitution of a Committee of Experts which met at Brussels to suggest a more equitable basis for allocating the expenditure. The Committee very soon decided that what is called the " benefit principle " can not be applied in the case of the League—as the League is founded to render maximum assistance to any member at any

[1] *Ibid.*

time. The benefit, therefore, would be common to all, and yet it could not, of course, justify the conclusion of advocating equal contributions from all. The only alternative was to adopt the principle of ability to pay.

To a large extent the economic upheaval following the war made it extremely difficult to determine a country's ability to pay either in terms of its national income, population, area or trade returns. After considering all the alternatives the Committee decided to base their decisions on two factors only, viz. the net public revenue of 1913 and the estimated population of 1919.[1] In the second case it was decided that for China or India the significance of their population should not exceed that of any European League Member with the largest population. On this basis China, India and Poland passed from the first to the second class, while Australia, Canada and South Africa went from the first to the third class. Of the 41 States thus dealt with 15 remained in the same category, 9 were advanced to a higher class and 17 were given a lower rating.[1]

This proposal was examined by the first Assembly in November, 1920, and still found to be defective in character. There was a suggestion to amend Article 6, but opinion was not unanimous in that respect. The defects of working under the rating

[1] *Ibid.*, p. 28.

of U.P.U. were, for instance, patent in the case of Great Britain and Liberia. In population the former had 50 times as many inhabitants as the latter, and in the matter of revenue it was about 4,250 times Liberia. In the existing scale, however, Great Britain was only 25 times Liberia (with 25 units against 1 of Liberia).

An Allocation Committee appointed towards the end of 1920 to study this question suggested the following rating:

Class I . . .	Units 90
Class II . . .	Units 65
Class III . . .	Units 35
Class IV . . .	Units 15
Class V . . .	Units 10
Class VI . . .	Units 5
Class VII . . .	Units 2

The maximum could thus be 45 times greater the minimum.

But to work on this suggestion it was necessary to amend Article 6 of the Covenant which fixed the rating in accordance with that of U.P.U. The Second Assembly, therefore, meeting in September, 1921, suggested such an amendment and proposed the following clause to replace paragraphs of Article 6 of the Covenant: "The expenses of the League shall be borne by the Members of the League in the proportion decided by the Assembly."

Although there was a general agreement among

the various members of the League that the classification proposed by the Allocation Committee was more equitable than that of the U.P.U., differences were still sufficient to prevent an amendment of the Covenant.

One principle admitted by the Allocation Committee seemed to facilitate the chances of agreement in 1922. It was recognised that countries like France that had suffered invasion in the Great War ought to be granted a concession in their contribution to the League. Thus France was granted a concession which reduced the contribution to 78 units while she was still in Class I. Some states who still thought that they would pay relatively more than the amount justified by their position maintained their opposition to the new arrangement. Poland at this moment stepped in with an offer to pay at the rate of 25 instead of 15 units. In the meantime the admission of Hungary gave a further margin of 4 units for reallotment.[1] This facilitated a reduction in the burden on some of the smaller states, and the Third Assembly therefore adopted the renewed scale for the budget of 1923, subject to an amendment of the Covenant, which was finally made possible in August, 1924, as the requisite number of ratifications, in accordance with Article 26 of the Covenant, were obtained. Further, the admission of Abyssinia and the Irish

[1] *Ibid.*, p. 38.

Free State into the League brought fresh contributions which were utilised in slightly reducing the rating of other states.[1]

The new rating thus adopted and, with slight modifications, at present in force, requires states of Class I to pay 105 (or less) units.[2] Great Britain thus pays 105. France, although in the same category, pays 79 units. It may be interesting to note that there is no other League member that pays 105 units. Great Britain therefore stands alone in this respect.[3] Italy and Japan paid 60 units each. Next comes India with 56 units to pay. The amount she pays is not justified under the present circumstances. She has the obligations of a full-fledged League member but not the rights of a full-fledged League member. She cannot lay an independent appeal to the League on any subject because her affairs are "the domestic concern" of Great Britain. Her payments incidentally amount to 1,704,202.45 gold francs as compared with 3,195,379.60 gold francs of Britain's and 821,669.05 gold francs (27 units) of Australia.[4]

[1] *Ibid.*

[2] A unit at present is roughly equivalent to a sum of £1,200 at the old par of exchange.

[3] See "The League Year Book," 1934.

[4] *Ibid.* for a full list of the contributions of all League Members.

The Gold Franc

The gold franc, adopted by the League of Nations on May 19, 1920, is equivalent to 0.3225806 of a gramme of gold, 90 per cent. fine.[1] When the Secretariat was transferred from London to Geneva the employment of a continental currency became desirable. The gold franc, therefore, with its pre-war ratio of 5.1826 to the American dollar was adopted as the monetary unit of the League.[2] The budget total is expressed in gold francs, the details of the expenditure being worked out in Swiss francs. For accounting purposes the gold franc and the Swiss franc are treated as of equal value.

Other Sources of Revenue of the League of Nations

Apart from these regular contributions of the members, the League has two other special sources of revenue, but being non-recurring and exceptional in character they are not of much importance. They are the following:

1. Contributions from member or non-member states for special functions. If in some conference or other between the member of the League and non-members a special expenditure occurs, the non-members are expected to contribute a share.

[1] "League of Nations Year Book," 1934, p. 28.

[2] League of Nations: "Financial Administration and Apportionment of Expenses," p. 16.

The cost of the World Economic Conference held at London in 1933 included a contribution of 17,629 Swiss francs from the U.S.A. Again in some special activity of the League which may benefit a particular non-member, that non-member is expected to share the expenses in proportion to the benefit it receives.

2. Contributions from private bodies or individuals made for special purposes. In 1933 the Rockefeller Foundation gave $50,000 towards the expenses of the Fiscal Committee in its study of international taxation problems. The same foundation gave another $125,000 for the promotion of analytical research work of the Financial Section and Economic Intelligence Service.[1] There have been a number of other contributions of varying nature.

The Expenditure Budget of the League.

The functions of the Allocation Committee must be clear from what has been said about it earlier. It still exists and is largely useful in studying the economic changes of members states that may justify a modification in their contributions. It also decides the scale at which a new member may have to pay its contribution.

. . . . . .

[1] "League of Nations Year Book," 1934.

The expenditure of the League is governed by the financial regulations published in 1931 and containing Amendments adopted at the 4th, 6th, 9th, 10th and 11th Ordinary Sessions of the Assembly.[1] As laid down there,[2] the estimates of the budget are divided into separate Parts : [3]

(*a*) For the Secretariat,

(*b*) For each Autonomous Organization, and

(*c*) For the Working Capital Fund.

[1] "League of Nations Year Book," 1934.

[2] League of Nations: "Regulations for the Financial Administration of the League of Nations," C.3.M.3. 1931. X. Article 9 (2).

[3] MODEL ESTIMATES.*

Part I. *Secretariat and Special Organizations of the League.*
Section 1. Ordinary Expenditure.
Chapter 1. Assembly and Council Sessions.
Chapter 2. General Services of the Secretariat, and so forth.
Section 2. Capital Expenditure.

Part II. *International Labour Organization.*
Section 1. Ordinary Expenditure.
Chapter 1. Salaries.
Chapter 2. Travelling expenses, subsistence and entertainment allowances and so forth.
Section 2. Capital Expenditure.

Part III. *Permanent Court of International Justice.*
Section 1. Ordinary Expenditure.
Chapter 1. Salaries.
Chapter 2. Duty and subsistence allowances, and so forth.
Section 2. Capital Expenditure.

Part IV. *Working Capital Fund.*

* C. 3. M. 3. 1931. X., p. 12.

Each *Part* (except that relating to the Working Capital Fund) is divided into two *Sections*, one for ordinary expenditure and the other for capital expenditure.[1] The *Sections*, in their turn, are subdivided into *Chapters* corresponding to the various services or categories of expenditure.[2]

Autonomous Organizations include the International Labour Organization, the Permanent Court of International Justice and any autonomous organization hereafter created by the Assembly. They are autonomous only in so far as their financial administration is separated from that of the Secretariat.

The general Budget of the League is preceded by a summary of the estimated income and expenditure for all the organizations covered by the Budget. This statement sets out the amount required to cover :

(*a*) Ordinary Expenditure.
(*b*) Capital Expenditure.
(*c*) Contributions, when necessary, to the Working Capital Fund.[3]

The Working Capital Fund is designed to meet, temporarily, the normal requirements of regular organizations of the League which cannot be paid out of income at the time when they are due to be met.[4] Assistance is given in the form of advances

[1] *Ibid.*, Article 9 (3).
[2] *Ibid.*, Article 9 (4).
[3] *Ibid.*, Article 11.
[4] *Ibid.*, Article 33.

from the Fund to the competent officials of the organizations,[1] and such advances are repaid to the Fund as soon as the necessary income is available.[2]

Article 1 of these Financial Regulations [3] sets up a Supervisory Commission to co-ordinate and control the income and expenditure of the League. The Budget as prepared annually by the Secretary-General, and its Annexes, are examined by this Commission, which prepares a report thereon in time for both documents to be dispatched to the Council and the Members of the League three months before the regular annual session of the Assembly.[4]

Collection of Revenue.

There is usually a delay in the payment of contributions to the Secretary-General. Under the ordinary procedure the Secretary-General informs the members, after the adoption of the Budget, that their contributions are due. If by April 1st

[1] Competent official means

(*a*) in the case of the Secretariat and non-autunomous organizations, the Secretary-General;

(*b*) in the case of the International Labour Organization, the Director of the Labour Office; and

(*c*) in the case of the Permanent Court of International Justice, the Registrar of the Court; or the duly authorised deputies of these officials. *Ibid.*, Definitions.

[2] *Ibid.*, Article 33.

[3] C. 3, M. 3. 1931. X.

[4] *Ibid.*, Article 16.

there is no response to this invitation, the Secretary-General is to repeat his request [1] at the end of three months and at the end of further three months.[1]

It is clear that there is no machinery by which the League is assured of a regular flow of income. At present, if the contributions do not come in due time, the Secretary-General can only inform and "repeat his request." A delay in contributions might mean also a delay in the payment of salaries to the staff and other expenses of the League. The Working Capital Fund was set up to meet this contingency, and has so far answered its purpose adequately. This does not, however, do away with the necessity of placing the League finances on a permanent basis by assuring to the League a few independent sources of income.

Auditing.

The audit of League expenses is as strict as can be desired. An auditor and deputy auditor are appointed by the Council, who in addition to their other duties examine all payments and vouchers three times during the year. For the purpose of their audit they are entitled to examine any League document, and the competent League officials must be prepared to give information or answer questions.

[1] *Ibid.*, Article 21.

APPENDIX III

THE AUSTRALIAN LOAN COUNCIL— CONSTITUTION AND MANAGEMENT

[AN EXTRACT FROM THE FINANCIAL AGREEMENT VALIDATION ACT, 1929]

3. AUSTRALIAN LOAN COUNCIL

(*a*) There shall be an Australian Loan Council which shall consist of one Minister of State of the Commonwealth to be appointed in writing from time to time by the Prime Minister of the Commonwealth to represent the Commonwealth, and one Minister of State of each State to be appointed in writing from time to time by the Premier of that State to represent that State. Provided that, if in the opinion of the Prime Minister or of any Premier of a State, special circumstances exist at any time which make it desirable so to do, a person who is not a Minister may instead of a Minister be appointed by the Prime Minister or the Premier as the case may be to represent the Commonwealth or a State as a member of the Loan Council. The name of each person appointed to represent a State shall be notified in writing by the Premier of that State to the Prime Minister.

(*b*) The member representing the Commonwealth on the Loan Council shall hold office during the pleasure of the Prime Minister of the Commonwealth and a member representing a State shall hold office during the pleasure of the Premier of the State which the member was appointed to represent.

(*c*) A decision in which all the members for the time being of the Loan Council concur shall be a unanimous decision of the Loan Council notwithstanding any vacancy then existing in its membership.

(*d*) A meeting of the Loan Council may at any time be convened by the member representing the Commonwealth, and shall be so convened upon the request of at least three members representing States.

(*e*) A majority of the members of the Loan Council shall constitute a quorum of the Loan Council for the exercise of its powers at any meeting. Provided that:

(i) a member may at any time appoint in writing a deputy to act in his absence; and any deputy so appointed may in the absence of the member exercise all the powers and functions of the member and his presence shall be deemed the presence of the member; and

(ii) an absent member who has not appointed a deputy may vote by letter or by telegram,

and in such case that member shall be counted as being present in relation only to the questions on which he has voted.

(*f*) The Loan Council may make rules of procedure including rules relating to places, times, and notices of meetings, and conduct of business at meetings, and from time to time may alter such rules.

(*g*) The Commonwealth and each State will from time to time while Part II of this Agreement is in force, and while Part III of this Agreement is in force, submit to the Loan Council a programme setting forth the amount it desires to raise by loans for each financial year for purposes other than the conversion, renewal or redemption of existing loans or temporary purposes. Each programme shall state the estimated total amount of such loan expenditure for the year, and the estimated amount of repayments which will be available towards meeting that expenditure. Any revenue deficit to be funded shall be included in such loan programme, and the amount of such deficit shall be set out. Loans for Defence purposes approved by the Parliament of the Commonwealth shall not be included in the Commonwealth's loan programme or be otherwise subject to this Agreement.

(*h*) If the Loan Council decides that the total amount of the loan programme for the year cannot be borrowed at reasonable rates and conditions it

shall decide the amount to be borrowed for the year, and may by unanimous decision allocate such amount between the Commonwealth and the States.

(*i*) If the members of the Loan Council fail to arrive at a unanimous decision under the last preceding sub-clause allocating the amount to be borrowed for any year, the amount to be borrowed for that year shall be allocated as follows :

(i) The Commonwealth shall, if it so desires, be entitled to have one-fifth or any less proportion of such amount allocated to the Commonwealth ; and

(ii) Each State shall be entitled to have allocated to it a sum (being a portion of the balance of such amount) bearing to the balance of such amount the same proportion which the net loan expenditure of that State in the preceding five years bears to the net loan expenditure of all the States during the same period. Provided that any State may, if it so desires, have allocated to it a sum less than the sum to which it is entitled under this sub-clause or no sum, and that when a less sum or no sum has been allocated to any State or States in manner aforesaid the amount then remaining available for allocation shall be allocated to the other States in the proportion which the net loan expenditure of each of such other States in the preceding five years bears to the net loan expenditure of all such other States during the same period. For the

purposes of this sub-clause net loan expenditure does not include expenditure for the conversion, renewal, or redemption of loans, but means the gross other loan expenditure of a State less any amounts of such expenditure repaid to the State other than moneys repaid to the State in manner stated in Part II, Clause 4 (*e*), or Part III, Clause 3 (i), of this Agreement.

(*j*) If the total amount to be borrowed as aforesaid for any year is to be borrowed by means of more than one loan the Loan Council may by unanimous decision apportion between the Commonwealth and the States the amount to be borrowed by each such loan other than the loan by means of which the balance of the total amount to be borrowed as aforesaid for the year is borrowed.

(*k*) If the members of the Loan Council fail to arrive at a unanimous decision under the last preceding sub-clause apportioning the amount to be borrowed as aforesaid by any loan the amount to be borrowed by that loan shall be apportioned between the Commonwealth and the States in proportion to the amount then to be borrowed as aforesaid for the Commonwealth and for each State for the year.

(*l*) The Commonwealth and each State will also from time to time, while Part II of this Agreement is in force and while Part III of this Agreement is in force, submit to the Loan Council a statement

setting out the amount it requires for each financial year for the conversion, renewal or redemption of existing loans.

(*m*) If the members of the Loan Council fail to arrive at a unanimous decision on any matter other than the matters referred to in sub-clauses (*h*) and (*j*) of Clause 3 and sub-clause (*b*) of Clause 4 of this part of this Agreement, the matter shall be determined by a majority of votes of the members.

On every question for decision by the Loan Council the member representing the Commonwealth shall have two votes and a casting vote, and each member representing a State shall have one vote.

(*n*) A decision of the Loan Council in respect of a matter which the Loan Council is by this Agreement empowered to decide shall be final and binding on all parties to this Agreement.

(*o*) In this clause the expressions "Prime Minister" and "Premier" include the persons for the time being respectively acting as such.

4. Future Borrowings of Commonwealth and States

(*a*) Except in cases where the Loan Council has decided under sub-clause (*b*) of this clause that moneys shall be borrowed by a State, the Commonwealth, while Part II or Part III of this Agreement is in force, shall, subject to the decisions of the

Loan Council and subject also to Clauses 5 and 6 of this Part of this Agreement, arrange for all borrowings for or on behalf of the Commonwealth or any State, and for all conversions, renewals, redemptions, and consolidations of the Public Debts of the Commonwealth and of the States.

(*b*) If at any time the Loan Council by unanimous decision so decides, a State may in accordance with the terms of the decision borrow moneys outside Australia in the name of the State, and issue securities for the moneys so borrowed. The Commonwealth shall guarantee that the State will perform all its obligations to bondholders in respect of the moneys so borrowed. For all the purposes of this Agreement, including the making of sinking fund contributions, the moneys so borrowed shall be deemed to be moneys borrowed by the Commonwealth for and on behalf of that State.

(*c*) If any State after the 30th June, 1927, and before this Agreement has been approved by the Parliaments of the Commonwealth and of the States, has borrowed moneys in the name of the State and issued securities for the moneys so borrowed, such moneys shall for all the purposes of this Agreement, including the making of sinking fund contributions, be deemed to be moneys borrowed by the Commonwealth for and on behalf of that State.

5. Borrowing by States

For any purpose (including the redemption of securities given or issued at any time for moneys previously borrowed or used in manner stated in this clause) a State may, while Part II or Part III of this Agreement is in force :

(*a*) Subject to any maximum limits decided upon by the Loan Council from time to time for interest, brokerage, discount and other charges, borrow moneys within the State from authorities, bodies, funds or institutions (including Savings Banks) constituted or established under Commonwealth or State law or practice and from the public by counter sales of securities, and

(*b*) use any public moneys of the State which are available under the laws of the State.

Any securities that are issued for moneys so borrowed, or used shall be Commonwealth securities to be provided by the Commonwealth upon terms approved by the Loan Council.

Where any such borrowing or use is solely for temporary purposes, the provisions of this Agreement, other than this clause, shall not apply.

Where any such borrowing or use is not solely for temporary purposes, and Commonwealth securities are issued in respect thereof, the moneys borrowed or used shall be deemed to be moneys borrowed by the Commonwealth for and on behalf

of the State, and may be retained by the State. A State may convert securities given or issued at any time by that State for moneys previously borrowed or used in manner stated in this clause. New Securities issued on any such conversion shall be Commonwealth securities to be provided by the Commonwealth upon terms approved by the Loan Council. The amount for which such new securities are issued shall be deemed to be moneys borrowed by the Commonwealth for and on behalf of the State.

If the moneys deemed under this clause to be moneys borrowed by the Commonwealth on behalf of a State, together with the amounts raised by the Commonwealth for and on behalf of the State exceed the total amount of loan moneys decided upon by the Loan Council as the moneys to be raised for and on behalf of the State for the financial year in which the money is deemed to be borrowed, the excess shall, unless the Loan Council otherwise decides, be deemed to be moneys received by the State in the following year on account of its loan programme for that year.

For the purposes of this clause counter sales of securities shall be deemed to mean sales of securities made at the offices of the State Treasury, and at such other places as may be decided upon by the Loan Council.

The Commonwealth shall not be under any

obligation to make sinking fund contributions in respect of moneys borrowed or used pursuant to this clause to meet a revenue deficit of a State, but the provisions of Clause 4 (*d*) of Part II, and of Clause 3 (*j*) of Part III of this Agreement shall apply respectively to all moneys borrowed or used for that purpose.

Except in cases where the Loan Council has otherwise decided under sub-clause (*b*) of Clause 4 of Part I of this Agreement a State shall not have the right to invite loan subscriptions by the issue of a public prospectus.

Notwithstanding anything contained in this Agreement, any State may use for temporary purposes any public moneys of the State which are available under the laws of the State, or may, subject to maximum limits (if any) decided upon by the Loan Council from time to time for interest, brokerage, discount, and other charges, borrow money for temporary purposes by way of overdraft, or fixed, special, or other deposit, and the provisions of this Agreement other than this paragraph shall not apply to such moneys.

6. Borrowing by Commonwealth

For any purpose (including the redemption of securities given or issued at any time for moneys previously borrowed or used in manner stated in

this clause) the Commonwealth may—while Part II or Part III of this Agreement is in force:

(*a*) Subject to any maximum limits decided upon by the Loan Council from time to time for interest, brokerage, discount and other charges, borrow moneys within the Commonwealth from authorities, bodies, funds or institutions (including Savings Banks) constituted or established under Commonwealth or State law or practice and from the public by counter sales of securities, and

(*b*) use any public moneys of the Commonwealth which are available under the laws of the Commonwealth.

Any securities that are issued for moneys so borrowed or used shall be Commonwealth securities, to be provided by the Commonwealth upon terms approved by the Loan Council.

Where any such borrowing or use is solely for temporary purposes, the provisions of this Agreement, other than this clause, shall not apply.

Where any such borrowing or use is not solely for temporary purposes, and Commonwealth securities are issued in respect thereof, the moneys borrowed or used may be retained by the Commonwealth. The Commonwealth may convert securities given or issued at any time by the Commonwealth for moneys previously borrowed or used in manner stated in this clause. New securities issued on any such conversion shall be Common-

wealth securities to be provided by the Commonwealth upon terms approved by the Loan Council.

If the moneys so borrowed or used are not borrowed or used solely for temporary purposes and Commonwealth securities are issued in respect thereof, and such moneys, together with other moneys borrowed by the Commonwealth for and on behalf of the Commonwealth as part of the total amount of loan moneys decided upon by the Loan Council as the moneys to be raised for and on behalf of the Commonwealth for the financial year in which the securities are issued, exceed such total amount the excess shall, unless the Loan Council otherwise decides, be deemed to be moneys received by the Commonwealth in the following year on account of its loan programme for that year.

For the purposes of this clause counter sales of securities shall be deemed to mean sales of securities made at the offices of the Commonwealth Treasury, and at such other places as may be decided upon by the Loan Council.

Notwithstanding anything contained in this Agreement, the Commonwealth may use for temporary purposes any public moneys of the Commonwealth which are available under the laws of the Commonwealth or may, subject to maximum limits (if any) decided upon by the Loan Council

from time to time for interest, brokerage, discount, and other charges, borrow money for temporary purposes by way of overdraft, or fixed, special or other deposit, and the provisions of this Agreement other than this paragraph shall not apply to such moneys.

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